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BALANCE SHEETS AND THE LENDING BANKER

A NEW ASSESSMENT OF ACCOUNTS AND
ACCOUNTING RATIOS IN RELATION TO
BANK ADVANCES

by

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To my Wife

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* <i>Accounts Analysis</i>	J. A. Mackinnon	Gee & Co.
	L. J. E. Troupe	
* <i>Balance Sheets, How to read and understand them</i>	Philip Tovey	Pitman
<i>Balance Sheet Values</i>	P. D. Leake	Gee & Co.
* <i>Bank Credit</i>	C. A. Phillips	MacMillan (New York)
* <i>The Banker as Lender</i>	F. E. Steele	Pitman
<i>Bankers and Borrowers</i>	John Brunton	Arnold
<i>Bankers' Tests</i>	F. R. Stead	Pitman
<i>Business Balance Sheets</i>	F. R. Stead	Pitman
* <i>Company Accounts</i>	Vivian H. Frank	Sweet & Maxwell
<i>Company Accounts and Balance Sheets</i>	Michael Moore	Jordan
* <i>Consolidated Accounts</i>	A. K. Fison	Heffer
* <i>Consolidated and other Group Accounts</i>	T. B. Robson	Gee & Co.
* <i>Design of Accounts</i>	F. S. Bray	O.U.P.
	F. B. Sheasby	
<i>Financial Accounting</i>	G. O. May	MacMillan (New York)
* <i>Guide to Company Balance Sheets</i>	Frank H. Jones	Heffer
<i>Higher Control in Management</i>	T. G. Rose	Pitman
* <i>The Internal Finance of Industrial Undertakings</i>	T. G. Rose	Pitman
* <i>The Principles and Interpretation of Accounts</i>	A. L. Ellis	Pitman
<i>Principles of Accountancy</i>	Stanley W. Rowland	Gregg
<i>Profits and Balance Sheet Adjustments</i>	P. Taggart	Pitman
* <i>Recommendations on Accounting Principles 1953</i>	The Institute of Chartered Accountants	Gee & Co.

and numerous other books and publications on Banking, Book-keeping and Accountancy

* *These publications are especially useful for supplementary reading.*

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PREFACE

It has been my privilege to lecture at the Staff College of my bank on balance sheets in relation to advance work. The importance of a practical approach to the subject was brought out by the keen questions of the students – mostly potential branch managers – and by their difficulty in linking effectively their knowledge of accounts, which was wide, to the day-to-day problems of the practical banker. They were thus eager to learn how accounts are used in the daily consideration of advance applications, as well as in the routine control of advances after they have been made. Actual examples from experience were absorbed with avidity.

Before presuming to talk on this key subject, I checked my notes against such authorities as were available. The paucity of strictly relevant literature, even in the fine library of the Institute of Bankers, was a revelation: I was thrown back very largely upon my own resources. That the talks contained much hitherto unpublished matter was confirmed by the instructors of the College. A *prima facie* case for this book was thus made out, and further systematic reading convinced me that, surprising though the discovery was, I should indeed be sailing in largely uncharted waters.

The book has been planned primarily as a study of balance sheets, from the special point of view of the banker. The emphasis is therefore upon accounts rather than upon bank lending. Indeed, it early became obvious that lending depends upon so many factors in addition to the accounts produced that the subject of bank lending deserves and requires more exhaustive treatment than is possible within the author's present strictly limited purpose. Little more is attempted than a preliminary examination of accounts as such, in order to fix their place in the larger field.

The book falls naturally into two not very clearly delimited parts: the first, Chapters I to X, is mainly theoretical; the second, Chapters XI to XVI, is mainly practical. The examples have been kept simple deliberately; for it is in this

way that a basic principle can best be illustrated, with a minimum of confusing complication. A number of financial ratios are discussed in Chapters VIII and IX, and certain detailed calculations are set out in Chapters V and XV. It is not suggested that the working banker would have the need, or indeed the time, to extract all these ratios or to make such calculations *as a matter of regular routine*. But in cases which call for more than ordinary analysis and closeness of control, the information thus obtainable may be invaluable.

For the benefit of any American readers, a short glossary of equivalent American accounting terms is given in Appendix IV. This may also be of some assistance to those keen English students of accountancy who feel that they cannot afford to ignore the very interesting theoretical and practical developments in the accounting field, which are taking place in the United States. The major recent development at home has been embodied in the new provisions of the Companies Act, 1948. Appendix III has therefore been included. It provides an index to those parts of the Act which affect company accounts, and is designed to facilitate quick reference to the Act in the ordinary course of banking business.

My best thanks are due to my wife, without whose encouragement and longanimity this book would not have been written: and to my old friend and mentor, Mr. J. Jabez-Smith, formerly Chief Controller of the Advance Department of Lloyds Bank, for reading the manuscript, and for his many wise suggestions. Known indebtedness to earlier authors has been acknowledged by footnote as far as possible. But in the course of years I may have absorbed the ideas of others, and so fully made them my own, that I am no longer conscious of my obligation. Careful therefore, like the Athenians of old, I would now make my propitiatory acknowledgement to 'THE UNKNOWN AUTHOR'.

The best critic of any book is the reader. If any such will write to me pointing out any errors, omissions or mistakes of emphasis which he may discover, I shall be most grateful.

The three goals of all study are Knowledge, Understanding and Wisdom, Knowledge is the reward of the industrious; Understanding, the prize of the thoughtful: but the crown of Wisdom comes only – as a free gift – to the elect few.

Therefore to have wisdom, or to impart wisdom, I make no claim. But I do trust that the argument of this book will, in some measure, add to the reader's knowledge, understanding. In that hope I now venture my modest argosy upon the sea of publication.

J. H. C.

71 Lombard Street, E.C.3.

November 1949

PREFACE TO THE SECOND EDITION

THIS book was launched three years ago in the hope that it would be of some help to my fellow-bankers. The call for a new edition so soon indicates that, with all its shortcomings, the work has to some extent realized this hope.

Of the shortcomings I am conscious enough: the opportunity has now been taken to remedy them as far as I am able.

A new section on hidden and secret reserves has been added to Chapter III. Insolvency and the theory of Cash Circulation have been brought together in one chapter which, though short, is vitally important. The diagram of cash circulation has been redesigned to illustrate the connection of different transactions with different subdivisions of the accounts. The space devoted to Ratios has been reduced and the argument has been tightened and rearranged.

Entirely new chapters have been added on Consolidated Accounts and that vexed question, the Breaking-up of a Balance Sheet. The chapter on Over-Trading has been expanded to include a detailed analysis of the serious effects of oppressive taxation on capital resources. As long as no Party has the realism and the political courage to face the issue the resulting problems for the lending banker will be real and serious.

Wherever in this book reference is made to Recommendations, the reader is referred to *Recommendations on Accounting Principles*, 1953 edition, issued by the Institute of Chartered

Accountants in England and Wales, and published by Gee & Company. This with its authoritative survey of current accounting problems should be on the bookshelves of every student of accountancy.

A criticism that the first edition dealt exclusively with industrial accounts was not well founded. In fact it dealt with principles applying to all balance sheets: industrial balance sheets were taken merely because they provided the most fruitful illustrations of those principles. It is hoped nevertheless that the varied skeleton balance sheets now introduced in Chapter XI will help readers to relate these fundamentals to the accounts of all sorts of undertakings.

The continued help of readers' suggestions and comments will be warmly welcomed.

J. H. C.

40 Victoria Street, S.W.1.

April 1954.

CHAPTER I

INTRODUCTORY

The Scope of the Book – Working Capital More Important than ‘Break-up’ Values – Standard of Accountancy and Banking Knowledge Assumed – No Formulæ (lending an art, not a science) – Lending Policy of the Banks Less Rigid – Increasing Importance of Accounts in Lending Judgement and Control.

AT the outset it may be helpful to state what this book does not attempt to do. It is not just another book about balance sheets and accounts. It does not attempt to teach the practice of book-keeping or to expound the theory and principles of accountancy. The new law relating to the accounts of companies is outside its scope. These matters have been more than adequately covered elsewhere. Nor does it attempt instruction in the wider aspects of practical banking; the legal and personal relationships between banker and customer; the law relating to accounts and securities; or the intricacies of bankruptcy and company liquidation. Here again there is an ample range of books from the elementary statement of first principles to the advanced treatise.

The narrower field of the interpretation of accounts in relation to bank lending, in so far as it has been worked at all, has received the attention of two kinds of writers – professional accountants and practical bankers, each bringing to the subject his own special sympathies and outlook, and each inevitably failing in some measure to give adequate weight to the other’s point of view. The mixture has thus tended to be unbalanced: either too much accountancy and too little banking;¹ or the reverse. Because the approach of the

¹ One accountant writer actually states that a bank lending to a company and requiring security, will often be ‘satisfied with a special issue to itself of the Company’s own *shares* or debentures, which are to be surrendered by the bank on repayment of the overdraft’. (The italics are the present writer’s.) As, on liquidation, the shareholders will receive nothing until the outside creditors *including the bank* have been paid in full, the shares could only be of value as security in just those circumstances where security would be superfluous! Short of liquidation, if the bank’s loan is unsafe, the shares would almost certainly be unsaleable. The issue and surrender of shares in the way suggested would involve some nice legal problems, too.

accountant is that of a specialist in figures, he can hardly avoid conveying the erroneous impression that balance sheets can speak with certainty, like modern Oracles of Delphi. Where, on the other hand, books on balance sheet interpretation have been written by bankers for bankers, the kind of analysis most suited to the requirements of the banker as lender has rarely been dealt with in sufficient detail. Even Stead's well-known *Business Balance Sheets* is suggestive, rather than exhaustive: it presents well-selected examples, but, perhaps intentionally, withholds full exposition. Moreover, the emphasis has tended to fall upon balance sheets in relation to *new* advances. The equally important place of succeeding accounts in the routine after-control of advances has been neglected.

Furthermore, too much emphasis has normally been placed upon the break-up values of the assets and the prospects of repayment by a 'gone' concern. The vital question whether the business can service the advance and effect reasonable reductions as a 'going concern', and the way in which the accounts can give the banker his answer, still await adequate treatment. Yet no one with practical banking experience would agree for one moment that when he makes an advance a banker usually expects to obtain repayment only by selling up his customer, or that, in fact, more than a small proportion of bank advances are cleared in this way.

The author's aim is therefore to take the reader a step further than the text-books of accountancy and practical banking have so far done. A knowledge of accounts at least up to Part I Book-keeping standard of the Diploma examination of the Institute of Bankers, and a comparable standard in Practical Banking, are assumed.

It may be asked with some force why accounts which are certified by an auditor as giving a 'true and fair view' of the state of a company's affairs, and of the profits for the year, should require interpretation at all. In the first place, it must be remembered that in the course of business life accounts are called upon to discharge a variety of functions. May¹ lists ten uses for financial accounts, including:

¹ *Financial Accounting*, George O. May.

'As a report of stewardship;
To determine the legality of dividends;
As a guide to dividend policy;
As a basis for granting credit;
As information for prospective investors;
As a guide to share valuation for existing holders;
As a basis for taxation;'

and he might well have added 'to assist the shaping of business and financial policy'. He goes on to emphasize that general purpose accounts are not suitable in all these cases and cannot be expected to serve all purposes equally well. In the second place, by their very nature and construction, balance sheets are not exclusively statements of fact, but present an amalgam of fact and opinion; and some of the figures rest upon estimation which may quite properly vary between wide limits.

'Accountancy is a strange mixture, being neither altogether a science nor altogether an art, so that it is perhaps not surprising if at times we are inclined to regard it mainly under the former aspect, and consequently tend to attach an absolute value to our statistics and indices; we must be on our guard against this error.'¹

As this book proceeds to combine the point of view of the accountant, preoccupied mainly with figures, with that of the practical banker, concerned mainly with people, it will be seen just how far the interpretation of accounts falls short of being an exact science. The reader who is looking for any easy formulæ, to save him the necessity for exercising judgement and honest-to-goodness hard thinking, will be disappointed. There are no such formulæ. For if experience of advance work teaches one lesson above all others, it is that no two accounts are exactly alike; possibly, perhaps, because no two people are alike.

Whatever may be true regarding accountancy, it may certainly be asserted that lending is an art, not a science: there is no place in the art of lending for rules of thumb. 'Financial analysis will not give an absolute answer to every question of doubt, but it can and will point to the direction in which

¹ *Design of Accounts*, F. Sewell Bray and H. Basil Sheasby.

further enquiries should be made.'¹ It is no denial of the importance of our subject to say that in assessing credit-worthiness the significance of balance sheets can easily be over-estimated. There are so many other factors to be considered.

That is no reason, however, why a banker should not extract the utmost information from accounts which come into his hands. It should be his aim to do so for as many customers as possible, whether they are borrowing or not. With the wise bank manager's encouragement, 'every customer should make a habit of submitting to his banker fully audited accounts each year, and should instruct his auditor to furnish any further information or explanations which the banker may desire. Thus, over a period of years, the banker would acquire a very considerable knowledge of the business affairs of his customer, and a greater measure of confidence would be established. It is, of course, assumed that the banker is qualified to read and appreciate the balance sheet which his customer submits and to ask pertinent questions regarding its build-up. If he is not so qualified he is of little real value either to his bank or to his customer. But most bankers are very able men, and reciprocate their customer's courtesy, not only by making a close study of the balance sheets submitted, but by taking a friendly interest in the business affairs of those customers.'² This is the view of an eminent Chartered Accountant and contains not only a counsel of perfection for customers which would make the banker's lot very much easier, but an appreciation of the positive value of balance sheets to offset the purely defensive conception so often associated with balance sheet lending. Apart from the increased value of the banker's help and advice which would follow, the close knowledge derived from the annual balance sheets would often make possible unhesitating and immediate financial assistance in an emergency. But the fundamental requirement is the banker's ability to read a balance sheet.

And what is the background against which the art of lending must now be exercised? The Clearing Banks' figures

¹ *Accounts Analysis*, Mackinnon and Troupe.

² Mr. E. E. Spicer, F.C.A., in a lecture reproduced in the *Journal of the Institute of Bankers*, January 1946.

for the 1937-52 period disclose a significant fall in the percentage of advances to total assets from 49.8 to 26.¹ The reasons for this are outside the scope of this book, and it will suffice to say here that Government control of borrowing, the restrictions imposed upon capital investment by licensing systems and physical shortages, and the restrictive effect on enterprise of heavy taxation and official controls, have all played their part.

The effect upon the position of banks as lenders is clear enough. The most remunerative outlet for their funds is advances, which they are anxious to extend as long as they can do so safely. Essential liquidity being assured in large measure by their other assets – they are prepared to lend today less conservatively, though always with due regard to the national interest. Some advances may be undertaken and carried where a long-term tie-up is inevitable unless the banker is prepared to force liquidation: this he is naturally reluctant to do until the last moment. The increasing importance of balance sheets and interim figures is therefore obvious. Losses will be made if ‘the last moment’ is misjudged. An intelligent reading of carefully chosen figures is the best, and often the only, insurance against such costly delay.

The new lending does not involve any marked departure from the cherished traditions of overall safety, but it does mean that the advance department of every bank in the country is sanctioning many loans and advances which before World War II, when the banks were almost fully lent and could pick and choose, would have had a lukewarm reception. Many a proposal today requires considerable re-shaping into acceptable form: and when the advance is granted, demands a degree of watchful aftercare not so usual before the 1939 war. Freer lending involves an increasing departure from ‘pawnbroking’ – mere advances against solid security with ample margin; and the banker of today must exercise real judgement based upon all relevant information, not the least important of which may be read in and between the lines of his customer’s balance sheet.

¹ Comparative table in Appendix I.

CHAPTER II

THE BALANCE SHEET

Distinction Between the Balance Sheets of Sole Trader, Firm and Corporation – Basic Structure of Balance Sheet – Different Connotations of 'Capital' – Net Worth and Surplus – Current Assets – The Place of Debtors and Bills receivable – Liquid Capital – Working Capital – a Percentage Balance Sheet – Liabilities Ratios – Assets Ratios.

It is essential to understand clearly the differences between the balance sheets of a sole trader, a partnership and a corporation, the most common of which is a company limited by shares and registered under the Companies Acts. To a lender these differences are important.

SOLE TRADER

It is customary for the business balance sheet of a sole trader to include only those assets which are actually employed in the business, and to disclose only those liabilities which arise directly out of it. Obviously, therefore, his balance sheet may give a very incomplete picture, and one on which a banker can rely only to a very limited extent. Moreover, it must be remembered that a sole trader is under no obligation either as to the production of a balance sheet at all, or as to its form and content where one is prepared. The same lack of legal obligation exists in relation to the auditor, if any. He does not normally certify the balance sheet of a sole trader, but merely signs it, and has no duty to disclose any reservations which may exist strongly in his mind. If, as is usually the case, the accounts have been prepared mainly with an eye to the taxation liabilities of the trader, the position, as far as the actual trading results are concerned, may sometimes be presented in the least favourable light possible, as a result of conservative stock valuations. Furthermore, the banker, when he examines the balance sheet of a prospective borrower, usually does not know whether the profit disclosed has actually been agreed by the Inspector of Taxes. A direct enquiry from the accountant, with the customer's consent,

will often reveal that substantial adjustments have been made. This indeed is true of all kinds of accounts.

On the capital side, too, the balance sheet of a sole trader may present a misleading picture. His overall position may be much better than the figures indicate, by reason of substantial personal assets apart from the business. On the other hand, there may be outside liabilities so large as to cancel out the apparent balance on capital account, or even to create a serious deficiency. The main value of a sole trader's accounts to a banker will therefore lie in the trading and profit and loss accounts, rather than in the balance sheet itself; for those accounts will at least disclose the scale of operations, whether profits are being earned in excess of drawings, and generally whether the business is making progress or not. But most bankers will be able to recall cases where, according to his audited accounts, a trader had been doing very well, but in fact, unknown to his bank manager until it was too late, he had been running a side-line which was losing money so heavily as to undermine the whole position. It should never be forgotten that behind the figures is a living person, with his share of human qualities and weaknesses. This fact the banker can ignore only at his peril.

FIRM

The balance sheet of a partnership, on the other hand, will, if properly drawn up, show all the liabilities of the firm: and the assets which appear therein will all be available to meet such liabilities. In other words, the position should not be worse than the balance sheet shows: from the point of view of a lender it may very well be much stronger; for, in addition to the partnership assets, a creditor of the firm has recourse (subject to the prior satisfaction of each partner's private debts) to the private means of all the partners (other than limited partners, if any) until he is paid out in full.

LIMITED COMPANY

The balance sheet of a limited company will show its complete position: its finances are entirely self-contained; the

full liabilities will be disclosed, and equally the total of assets available to meet them. Only in the case of a company limited by guarantee, or where the balance sheet indicates that some of the share capital is not fully paid-up, can a creditor look beyond the assets shown, for repayment of his debt. In the case of companies, too, a substantial minimum of information is obligatory, and the protection of the certificate of a qualified auditor is, under the new Company Law, a very real thing.

To sum up, a company balance sheet is the most exact: that of a firm the most conservative; and that of a sole trader the least complete and reliable. Subject to these fundamental differences, which must always be kept in mind, nothing will be lost if the rest of this book concerns itself mainly with company balance sheets. *Mutatis mutandis*, the same principles of interpretation apply to all three types, and all balance sheets have the same essential structure, even those somewhat complicated and forbidding examples drawn up on the double account system.

THE BASIC STRUCTURE OF A BALANCE SHEET

In these days anything other than accounts prepared from proper double entry books can be ignored. In current banking practice statements of affairs prepared by the customer for the banker's information have almost gone out of use, excepting possibly in the case of a small farmer. Changes in the basis of assessment for income tax, putting the farmer on the same footing as any other trader, will tend to make properly audited accounts the rule, even in this, the most conservative of industries. As a direct result of the fact that initially every debit is represented by a corresponding credit somewhere in the accounts, a balance sheet is a statement ultimately presenting a twofold view of the fund of assets controlled by the business. Details vary with the special requirements of differing types of business, but in essence all balance sheets are constructed upon the framework set out below:

BALANCE SHEET, 31st DECEMBER 1948

	£	s.	d.		£	s.	d.
1. Proprietors' Capital	0	0	0	4. Fixed Assets .	0	0	0
2. Long-term Liabilities	0	0	0	5. Current Assets	0	0	0
3. Current Liabilities .	0	0	0	6. Intangible Assets	0	0	0
	<hr/>				<hr/>		
	£0	0	0		£0	0	0
	<hr/>				<hr/>		

Thus the left-hand side is a statement of the accountability of the concern for its fund of assets at the balance sheet date, first of all to outside persons (items 2 and 3) and then to its proprietor or proprietors. The right-hand side sets out in classified form (items 4 to 6 inclusive) the assets comprising the identical fund at the same date. This is elementary but important, because it explains and justifies the different and apparently contradictory uses of the word 'capital'. As the capital fund of a company is exactly the same fund whether regarded from the angle of accountability or make-up, there is nothing illogical in referring to certain items on the left-hand side as 'proprietors' capital' and 'loan capital', while at the same time referring to certain groups of assets as 'fixed capital', 'circulating capital' and 'liquid capital'. The first two indicate the *source* of part of the capital fund: the next three the *functions* of certain parts of the fund. Nor indeed is there anything unsound in combining certain items from both sides of the balance sheet to ascertain the 'working capital', which is the excess of current assets over current liabilities. Example I will make this clear. This is a simple balance sheet of a manufacturing company which, while excluding all unnecessary frills, retains all the essentials, and, although of earlier date, conforms to the requirements of both the Companies Act, 1948, and the Recommendations of the Institute of Chartered Accountants. There is, of course, no particular merit in using for the purpose of illustration the accounts of a manufacturing company. This book is concerned with basic principles: the figures of any other type of business would serve almost equally well. Placed opposite to it, for convenience of comparison, is a simple and exceedingly useful form of analysis, Example II, which has extracted the essentials of the balance sheet, and at the same time serves to explain the various uses of the word 'capital' to which reference has been made.

Example 1
'MANUFACTURERS LIMITED'
BALANCE SHEET, 31st March 1946

	£		£	£
<i>CAPITAL</i> , authorized, issued and fully paid-up:		Freehold Factory at cost	.	100,000
100,000 Ordinary shares of £1 each	.	Less Depreciation	.	1,400
Reserve	.		.	98,600
Profit and Loss Appropriation Account	.	Plant and Machinery at cost	.	70,000
		Less Depreciation	.	20,000
			.	50,000
5% Debentures, secured	.	Fixtures and Fittings, at cost	.	7,000
Provision for Taxation	.	Less Depreciation	.	2,000
Trade Creditors	.		.	
Provision for Dividend (Subject to confirmation by the General Meeting)	.	Raw Materials	.	5,000
		Work-in-progress	.	5,000
		Stock of Finished Goods	.	7,500
		Debtors	.	20,000
		Bills Receivable	.	24,500
		Tax Reserve Certificates	.	2,500
		Quoted Investments, at cost	.	5,000
		(Market value, 31/3/46, £3,841)	.	3,500
		Cash at Bank and in Hand	.	9,000
		Discount on Debentures	.	2,100
		Less amount written off	.	700
			.	1,400
				<u>£232,000</u>

AUDITORS' CERTIFICATE

We report to the shareholders of 'Manufacturers Limited' that we have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purpose of our audit. In our opinion proper books of account have been kept by the company as far as appears from our examination of those books. We have satisfied ourselves of the existence of the securities of the Company. We have examined the above Balance Sheet and annexed Profit and Loss Account, which are in agreement with the Company's books. In our opinion and to the best of our information and according to the explanations given to us, the said Balance Sheet and Profit and Loss Account give the information required by the Companies Act, 1948, in the manner so required, and the Balance Sheet gives a true and fair view of the state of the Company's affairs as at 31st March 1946, and the Profit and Loss Account gives a true and fair view of the profit for the year ended on that date.

It will be seen that the complete balance sheet could quite well be drawn up in this way. In fact, some accountants already use this modified layout as their normal form of presentation. The practice has much to commend it as an aid to the uninitiated in their reading and understanding of company balance sheets. Such analysis applied to any balance sheet will bring out the cardinal points: Share capital, Surplus, Net worth, Fixed capital, Loan capital, Net fixed

Example II

'MANUFACTURERS LIMITED'

ANALYSIS OF BALANCE SHEET, 31st March 1946

(£000's omitted)

		£	£
<i>Fixed Capital</i>	Fixed Assets	153.6	
<i>Loan Capital</i>	<i>Less</i> Fixed Liabilities	70	
		<hr/>	
	NET FIXED ASSETS		83.6
<i>Floating Capital:</i>	CURRENT ASSETS:		
	(1) <i>Circulating Assets</i>		
	Raw Materials	5	
	Work-in-progress	7.5	
	Stock of Finished Goods	20	
	Debtors	24.5	
	Bills Receivable	2.5	
		<hr/>	
<i>Total Circulating Capital</i>		59.5	
	(2) <i>Liquid Assets</i>		
<i>Liquid Capital</i>	{ Tax Reserve Certificates	5	
	{ Investments	3.5	
	{ Cash	9	
		<hr/>	
<i>Total Floating Capital</i>	= Total Current Assets	77	
	<i>Less</i> Current Liabilities	22	
<i>Working Capital</i>	= NET CURRENT ASSETS	<hr/>	55
			<hr/>
	TOTAL NET ASSETS		138.6
			<hr/>
	Represented by:		
<i>Share Capital</i>	Share Capital	100	
<i>Surplus</i>	{ Reserve	30	
	{ Profit and Loss	10	
		<hr/>	140
	<i>Less</i> Fictitious Assets		1.4
			<hr/>
<i>True Net Worth</i>			£138.6
			<hr/>

assets, Floating capital (or current assets), Circulating capital, Liquid capital, Working capital, most of which are discussed in detail in this and following chapters.

This form of analysis is equally applicable to balance sheets presented in the double account form, which is usual, though not obligatory, for water companies. The other public utility undertakings, railways and electricity and gas supply companies, which were required by statute to present accounts in this form, have been taken into public ownership.¹

SURPLUS AND NET WORTH

The SURPLUS in the present case comprises undrawn (or 'ploughed back') profits, whether transferred to reserve, or left unallocated in the profit and loss appropriation account. It may also include capital reserves, excess profits tax post-war refund account, and any other items on the left-hand side of the balance sheet which, had the business been wound up at the balance sheet date, would not have involved accountability to outside persons. In other words, the SURPLUS is the amount which (disregarding liquidation expenses, which in actual practice would probably be heavy) would have been returnable to the shareholders, *in addition to their capital*, had the assets all realized their book value. NET WORTH, which is the real total proprietors' interest in the company, is thus made up of the paid-up share capital, plus the SURPLUS. In estimating net worth in his assessment of creditworthiness, a banker will naturally make a deduction for intangible or fictitious assets, which most certainly would not realize their book value in any circumstances. In the present instance £1,400 (discount on debentures) has been subtracted from the nominal net worth figure ascertained as above, to arrive at the true figure. The usual fictitious or intangible assets deductible in this way are:

¹ Although nationalization is rapidly reducing the number of the enterprises which draw up their accounts on the double account system, such accounts are still with us, and cannot yet be regarded as an anachronism. The only real difference between double account and single account forms is in the presentation, and either can be produced for the same business from the same set of books.

1. Preliminary (or formation) expenses;
2. Expenses or discount in connection with the issue of capital or debentures;
3. Suspense accounts, opened to facilitate the spread of large revenue expenditure over several years (e.g. the cost of an advertising campaign or a major programme of re-fertilization on a farm);
4. Adverse profit and loss balance, representing accumulated losses;
5. Directors' loans¹ when they are less than undoubted and may represent money permanently withdrawn from the business;
6. Goodwill;
7. Patents and Trade Marks;

and any other items which do not represent real assets. Numbers 1 to 4 inclusive may always be treated as valueless. Whether numbers 5 to 7 fall into the same category is a question of fact which must be resolved by full enquiry. A director's loan may be a gilt-edged asset, and goodwill or trade marks, in exceptional cases, the most valuable assets of all; only close knowledge of the true position can decide.

CURRENT ASSETS

In the interests of clear thinking the use of the term 'liquid assets' as synonymous for 'current assets' should be avoided. Opinions may differ, but, in the absence of a very desirable standardization, it is important for each individual to make his own selection of terms, to understand clearly what he means by them, and then to use them only in the understood sense. In the present author's view it is desirable to employ the term 'current assets' for all the assets comprising the floating capital, and to confine the word 'liquid' only to those current assets which are so in fact, that is to say to those assets which under all usual circumstances can be turned quickly into cash. The remainder of the current assets are best and

¹ In spite of the drastic provisions of the Companies Act, 1948, bankers may still be troubled by directors' loans in a private company's balance sheet, with the added question whether it is an *exempt* private company or not.

most accurately described as 'circulating assets': no better term is available to indicate the changes which take place in this group of assets in the normal course of business. As to the exact point at which the line separating the circulating from the liquid assets should be drawn, there is room for different opinions. Some writers include debtors amongst the liquid assets. To an extent this may be justified; for a certain proportion of the book debts, varying between different businesses, and even in different areas and at different seasons in the same business, can always be collected quickly, though at some risk of losing the debtor's goodwill! Sometimes the special structure of a business entitles one to rely on so steady an inflow of debt collections that the closest budgeting of outward payments is possible. Typical examples are insurance companies, building societies and hire purchase companies. With his justifiably more conservative approach, however, a banker would be ill-advised to regard debtors as quick assets: indeed, it may well be that just when it is most necessary for money to be collected quickly, book debts will be hardest to get in.

The suggestion that bills receivable should be grouped with the liquid assets is, at first sight, more plausible; for a bill can be turned into immediate cash by discounting; this is usually possible, however, only if the acceptor is good, or the bill is backed by an acceptable surety. On the other hand, a bill or promissory note 'as compared with the book account is objectionable from the standpoint of both bank and borrower, because it is difficult to take quick legal action for recovery should doubt arise as to the solvency of the signer. Effective action cannot be taken until the note matures',¹ for until maturity there can be no dishonour giving a right of action against the parties liable. 'In the case of an open account, on the other hand, the legal means of recovery are quickly available',² for although, in the hope of saving himself expense the creditor usually sends out his account and issues a preliminary warning, he is not legally obliged to do so, and can issue a writ for recovery as soon as the money is due, even though no preliminary demand whatever has been made. In law it is the duty of the debtor to seek out his

¹ *Bank Credit*, C. A. Phillips.

² *ibid.*

creditor and to pay what he owes. A bill receivable can usually be turned quickly into cash when the acceptor is good, but may be much less 'quick' than a debt on open account when there is reason to fear that the debtor is getting into difficulties and urgent action is essential. On balance, therefore, it is better, at least for the banker, to class bills receivable with ordinary debtors, and to regard both as circulating rather than liquid assets.

WORKING CAPITAL

Example II clearly shows the nature of working capital, or net current assets, and the method of ascertainment from the balance sheet. The amount of the working capital is the excess of current assets over current liabilities; it would have remained as part of the net worth had the creditors been paid off at the balance sheet date. This assumes that the fixed liabilities will be satisfied out of the fixed assets, upon which they are often, but not necessarily, secured. It is then obvious that the net fixed assets, after satisfying the fixed liabilities, plus the working capital, will equal the net worth. This will be true notwithstanding that either net fixed assets or working capital might be a minus quantity; or even both, in which case the net worth would be a minus quantity, too, indicating a position where the whole of the proprietors' stake and some of the creditor's money has been lost. Such book loss might be increased or decreased on actual realization. The proprietors' stake in 'Manufacturers Limited' (Illustrations I and II) on 31st March 1946 was represented by £83,600 of net fixed capital and £55,000 of working capital, the remainder of the tangible assets being notionally appropriated to offset the amounts due to the loan and current creditors.

The whole question of working capital is of such importance to lending bankers that it will be dealt with in a separate chapter, with a detailed consideration of the whole current position.

PERCENTAGE BALANCE SHEET •

Much useful information can be extracted from a single

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balance sheet, an operation which can be greatly helped by adding thereto against each figure its percentage of the balance sheet total. This makes easier the comparison of one item with another, whether on the same side, or on opposite sides, and simplifies the working out of various financial ratios. A percentage balance sheet, based upon Example I, is set out below:

Example III

		(£000's omitted)			
	%	£		%	£
Capital	43	100	Fixed Assets	66	153.6
Surplus	17	40	Circulating Assets	26	59.5
Loan Creditors	30	70	Liquid Assets	7	17.5
Current Liabilities	10	22	Fictitious Assets	1	1.4
		<hr/>			<hr/>
		100 £232			100 £232
		<hr/>			<hr/>

Here we have in easily assimilable form the liability ratios and those for the different classes of assets. It will be noted that capital and long-term loans amply cover the fixed assets and provide a substantial portion of the current assets, the balance of which has been furnished by profits left in the business and by the current creditors. Reliance on creditor finance is satisfactorily small at 10% and capital and surplus have supplied 60% of total resources. Two-thirds of the capital fund of the company is represented by fixed assets, but no inference can be drawn from this fact without a close knowledge of the business itself.

LIABILITY RATIOS

The liability percentages bring out clearly the respective investments in the business of the proprietors, the loan creditors, the bank (under the new requirements of the Companies Act bank loans and overdrafts must be shown separately from other creditors) and the other current creditors. Variations in these different interests from year to year are important indications of changes in the business and in its financial strength. An increasing reliance upon the bank or on outside creditors is a danger signal, and the banker will especially watch that his stake does not become

disproportionate to that of the shareholders. In the case of a private company where it is customary to insist upon the personal guarantees of the directors with or without supporting security for any bank accommodation, it will be recognized that the whole position, and not merely the balance sheet, must be taken into account. The net worth of the proprietors, as shareholders, plus their backing as individuals in the form of outside security, may warrant an extent of bank assistance far beyond what would be justified by the net worth alone.

ASSETS RATIOS

Current assets constitute the vital, organic part of the business; indeed, they are, in a very real sense, the business itself. The fixed assets correspond to the stage setting and the properties in a theatrical production, but 'The play's the thing'. All the action and achievement of the business leading to progress and profits (other than capital profits) take place in the movement or turning over of the circulating assets. Against a lavish background a flimsy play, with poor direction and an ineffective cast, looks ridiculous. In business a similar disproportion between fixed and floating capital may well be disastrous. For it must not be forgotten that it is only the circulating assets which earn profits to provide an adequate return on the capital employed, and a sufficient surplus for amortization.

A business overloaded by fixed assets is like an overbodied car. It is sluggish instead of lively, unresponsive instead of flexible. The current/fixed assets ratio has for the financial director the same significance as the power/weight ratio has for the automobile engineer. And that business will progress fastest and farthest which has only the necessary minimum of fixed asset deadweight to carry.

Clearly the proportion of fixed to current assets will vary with businesses of different types, and in the same business in different stages in its development. Often in the case of a manufacturing business an initial over-plus of fixed assets will gradually be corrected by a build-up of current assets as profits are earned and ploughed back into the business. The balance sheet of a retail business which holds its shop on lease

will show little more in the way of fixed assets than fixtures and fittings, and perhaps delivery vans. On the other hand, a retailer who sells exclusively for cash will, in the absence of debtors, carry circulating assets much lower than those disclosed in the balance sheet of a similar business which sells on long credit, but should carry higher cash balances. A manufacturer, in addition to his buildings, must carry heavy fixed assets in the form of plant and machinery, which may or may not be accompanied by increased current assets under the headings of raw materials, stores and work-in-progress. Many undertakings require nothing in the way of fixed assets beyond a few pieces of office furniture. The permutations and combinations of the different asset relationships in business balance sheets are limitless.

Nevertheless, the ratio of fixed assets, current assets and intangible assets is always important. It is 'obvious that, other things being equal, the less capital locked up in fixed assets compared with that in circulating and liquid assets, the healthier the outlook; and it may certainly be regarded as desirable that intangible assets should be in evidence as little as possible. But every business must be considered on its merits, and in relation to its class, and hasty judgements are to be deprecated . . . in investigating the position of an undertaking over a series of years, the gradual shifting of the proportion which these groups bear to the assets as a whole, may sometimes give the first indication of an unsound financial position'.¹

Comparison of items on *opposite* sides of the balance sheet will be equally suggestive. Even if we ignore the more significant relationships which are dealt with in some detail in the pages which follow, thoughtful and intelligent comparisons of the figures on either side of the percentage balance sheet are often fruitful in practice. 'Quite apart from all questions of ratios there is still a great deal of value in the inferences to be drawn by making a straightforward comparison between two successive balance sheets or revenue statements, and abstracting the counterbalancing increases and decreases. A careful study of these positive and negative differences may be instructive, particularly in the case of

¹ *Balance Sheets*, Philip Tovey.

balance sheets, since they illustrate the total movements over a defined period of time among the elements common to the essential structure of accounts, viz. assets, liabilities and proprietorship. If such "straight-line" comparisons are varied over short and long periods they can be made to contribute much to the interpretation of accounts.'¹ Time spent in brooding over figures is seldom wasted.

¹ *Design of Accounts*, Bray and Sheasby.

CHAPTER III

THE BALANCE SHEET (*continued*)

Reserves: Capital Reserves, Revenue Reserves – Provisions – Hidden and Secret Reserves – Bills Payable – Bills Receivable – Balance Sheet Notes – The Valuation Element – The Auditor's Report.

THE essential nature of a balance sheet has been dealt with. This chapter will deal with sundry matters which at first sight have only small direct bearing upon the reading of balance sheets by bankers. Their consideration will, however, extend and clarify our understanding of the meaning of balance sheets generally.

RESERVES

The demonstration of the make-up of net worth in Example II serves to emphasize the true nature of reserves and will help to remove certain popular misconceptions of their significance. Reserves are of two main kinds: capital reserves arising from exceptional capital transactions; and revenue reserves built up by transfers from profit and loss account. Each forms part of the surplus, but the main distinction arises in the disposal of such reserves. Capital reserves are those which cannot be regarded as available for distribution¹ through profit and loss account: all other reserves are revenue reserves,² and can always be re-transferred to the appropriation account and distributed.

Capital reserves are accumulated in various ways, and may include: premiums on shares or debentures issued; capital profits arising from the sale of fixed assets at a figure in excess of their book valuation; increase of value of fixed assets over book values, on revaluation;³ the 'capital redemp-

¹ In the light of the explanation of the nature of a balance sheet in the previous chapter, it must be appreciated that, strictly speaking, reserves are incapable of distribution. It is cash, *an asset*, which is distributed; and the reserve balance on the accountability side of the balance sheet is reduced in step.

² Companies Act, 1948, 8th Schedule, para. 27, (1), (c).

³ Not generally considered to be sound practice.

tion reserve fund'¹ created out of revenue in connection with the redemption of redeemable preference shares; and 'excess profits tax post-war refund account'.

Revenue reserves, on the other hand, are the result of one or more book entries between two credit accounts which, of course, figure on the liabilities side of the balance sheet. They do not represent any change whatever in the total or make-up of the assets. Example I shows:

Reserve	.	£30,000
Profit and Loss	.	£10,000

If the £30,000 were re-transferred to profit and loss account, the balance sheet would not be weakened, or indeed altered, in any really material way. The surplus and net worth remain exactly the same. There is no more merit or significance in a transfer of profits to reserve than in the transfer of half a crown from a man's trousers pocket to his waistcoat. He still has exactly the same amount of cash available to spend as he wishes. It is true that prudent directors like to reduce the apparently distributable balance to discourage shareholders from looking for higher dividends. Properly regarded, this is merely a benevolent deception; for the amount on revenue reserve is still in fact available for distribution. The point is stressed because many people are more impressed by a balance sheet showing £30,000 on reserve and a carry forward of £10,000 only, than by one showing no reserve, and a carry forward of £40,000. In so far as the creation of a revenue reserve indicates the intention to conserve working capital by curtailing dividends, it is an admirable gesture. It is not, and cannot be, anything more. The psychological value of the practice cannot, however, be gainsaid.

There is, of course, no justification for going to the other extreme and regarding revenue reserves as something definitely undesirable, as one writer has done. 'A credit balance on profit and loss account . . . although not actually called a reserve, is in effect a reserve, although not specifically represented by some definite asset. . . . It is supposed to strengthen the balance sheet and enhance the company's

¹ Companies Act, 1948, Sec. 58, (1), (d).

financial standing, but the correct inference to be drawn from such reserve, if of any appreciable size, may be that the company is under-capitalized. . . . Sometimes instead of keeping the accumulated profits in the profit and loss account they are placed in a general reserve, but . . . the result is the same.

'On the whole, when there appears in the balance sheet a reserve . . . or any item with a similar general designation, then frozen capital may be suspected and a lack of ready money.'¹ Surely, however, it is not a question of suspicion. Whether there is adequate ready money is a question of fact which will be revealed by an examination of the asset make-up in relation to current liabilities and other relevant factors:² it will not be affected whether or not the left-hand side of the balance sheet discloses a reserve, or profit and loss balance. Fortunately there is hope that the sound and old-fashioned practice of ploughing back profits as the natural method of increasing effective capital will not be discouraged by the original views just quoted.

There is almost equal misunderstanding of the effectiveness of setting aside profits to meet either specific future liabilities (in which case it will now be called making a *provision*, under the Companies Act, 1948)³ or as a reserve to meet unknown contingencies. Contra entries between credit accounts in the company's books cannot affect the assets. In common with all the other items making up the left-hand side of the balance sheet, reserves and provisions are repre-

¹ *Balance Sheets Explained, Analysed and Classified*, H. Kaner.

² See Chapters V, VIII and IX, *post*.

³ While it is not very material to the banker, it is of interest to point out that the wording of Paragraph 27 of the 8th Schedule of the Companies Act, 1948, sets a nice little problem in interpretation. Recommendation VI of the Institute of Chartered Accountants, which the Act was expected to embody, is clear enough. The term 'reserve' is to be applied to sums set aside out of profits which are not designed to meet any specific liability known to exist at the date of the balance sheet. The term 'provision' is to be used for sums set aside to meet known specific requirements, *whether the amounts involved can be determined with substantial accuracy, or not*. The Schedule reproduces the same conception of a reserve, but confines the expression 'provision' to sums set aside for (1) depreciation, renewals or diminution in value of assets, (2) providing for any known liability *of which the amount cannot be determined with substantial accuracy*. It appears, therefore, that a sum set aside for a known future liability of *known* amount is, by definition, neither a provision nor a reserve! To meet this difficulty the addendum to Recommendation VI now recommends that such sums set aside should be grouped with creditors, since they represent liabilities or accruals.

sented by the changing assets as they are from day to day. If, when cash is needed, there is no cash, it is not the slightest help if a large figure appears on the other side of the balance sheet against 'reserves'. A business with no reserves and plenty of cash or other liquid assets is far better able to meet payments than one with large reserves and no liquid assets. The following skeleton balance sheets show the position of two companies at a date when each requires £15,000 to replace machinery or renew a lease:

COMPANY A

	£		£
Capital . . .	50,000	Fixed Assets . . .	40,000
Mortgage . . .	30,000	Stock . . .	53,900
Reserve . . .	20,000	Debtors . . .	15,000
Profit and Loss Account	5,000	Cash . . .	100
Creditors . . .	4,000		
	<hr/>		<hr/>
	£109,000		£109,000
	<hr/>		<hr/>

COMPANY B

	£		£
Capital . . .	50,000	Fixed Assets . . .	40,000
Mortgage . . .	30,000	Stock . . .	15,000
Reserve . . .	<i>nil</i>	Debtors . . .	17,000
Profit and Loss Account.	5,000	3½% War Stock.	10,000
Creditors . . .	7,000	Cash . . .	10,000
	<hr/>		<hr/>
	£92,000		£92,000
	<hr/>		<hr/>

On the face of it Company A could only find the £15,000 with the greatest difficulty and would have to resort to borrowing; Company B has the necessary liquid resources all ready. It is true, too, that Company A has at the same time reserves of £25,000, shortage of cash and perhaps even frozen capital (whatever that may mean): but the first is not the cause of, or in the slightest degree connected with, the last two. The probable explanation of Company A's difficulties is simple and obvious. Assuming that it does not sell largely for cash, the company is probably carrying too much stock either by reason of over-buying, or falling sales, or both. If a practical business man has to make sure of ready money for such a special purpose as we are considering, he will accumulate it

either in the bank or in the form of outside and readily realizable investments, and adjust his buying and selling to that end. A ledger transfer between two nominal accounts has nothing to do with it. Having achieved his goal by using his common sense, the business man will be quite content to leave the question of book-keeping entries to his accountant.

RESERVE FUND

'The term "reserve fund" should only be used where a reserve is specifically represented by readily realizable and earmarked assets.'¹ Unfortunately the Companies Act, 1948, perpetuates an exception to this sound tradition in relation to the redemption of fully paid redeemable preference shares.² Although it is not covered by the official recommendations, there seems no reason why the term 'provision fund' should not be used in the same way.

But what happens to a reserve fund built up out of profits, which has served its purpose? For instance, a company has created by transfer from profits a factory extension reserve fund, thus:

Factory Extension Re- serve Fund . . .	£10,000	Factory Extension Re- serve Fund Invest- ments: £10,000 4% Fund- ing Stock at cost .	£10,000
-------------------------------------------	---------	--------------------------------------------------------------------------------------------------	---------

In due time the stock is sold for £10,000 cash and the cash is spent on a new factory wing. The books will now show:

Factory Extension Re- serve Fund . . .	£10,000	Additions to Freehold Factory . . .	£10,000
-------------------------------------------	---------	----------------------------------------	---------

But there is no longer any reason for retaining the reserve fund item in the balance sheet; and it is no longer a true reserve *fund*. It would therefore as a matter of financial practice, be transferred to general reserve: as it was accumu-

¹ Recommendations on Accounting Principles by the Institute of Chartered Accountants, No. VI, para. 46.

² Companies Act, 1948: Sec. 58, (1), (d), which provides that redeemable preference shares can be redeemed only out of the proceeds of a fresh issue of shares, or out of distributable profits. Where the latter course is followed there must be transferred from such profits (whether standing to the credit of the profit and loss account or of a revenue reserve) to a 'capital redemption reserve fund' a sum equal to the nominal amount of the shares redeemed.

lated out of revenue, it *could* equally well be re-transferred to profit and loss appropriation account. It will be self-evident that the investments could equally well have been bought and later used in this way whether the Reserve Fund had been set up or not.

PROVISIONS

We have seen that the creation of revenue reserves for general purposes merely changes the make-up of the surplus without affecting its total. Provisions for specific *future* liabilities have a similar effect. All other provisions fall into two main classes: provisions for depreciation in value of fixed assets; and, in the working capital sphere, provisions for diminution in value of current assets, or for current liabilities; and provisions of both classes *decrease net worth*.

Provisions for depreciation of fixed assets will be shown in the balance sheet as deductions from the respective asset values.¹ The effect is to decrease net worth (by reason of the reduced profit and loss account balance) and fixed asset values, by equal amounts.

Provisions for liabilities such as taxation (other than future taxation)² or proposed dividends, increase current liabilities and therefore decrease working capital in step with a decrease in net worth.

Provision for bad and doubtful debts (we must in future forget our old friend, 'bad debts reserve') will normally be deducted from debtors, thus reducing current assets and therefore working capital in step with the reduction in net worth.

The point that provisions for depreciation of fixed assets do not reduce working capital should be especially noted for future reference.

HIDDEN AND SECRET RESERVES

Hitherto attention has been given only to reserves created by normal open accounting procedure and visible in the

¹ Recommendation VIII (12), para. 78.

² That is, taxation for fiscal years later than the first one commencing after the close of the company's account year. Sums set aside for this purpose should not be described as provisions but as reserves, and should be grouped with the other reserves (Addendum to Recommendation III, (a)).

accounts for all the world to see. There is, however, a whole range of reserves which are not disclosed in the accounts and it is important to consider them both in relation to the method of their creation and their use. Classified according to their method of creation they are:

HIDDEN RESERVES

These are normal reserves or provisions created in the ordinary way by transfers from the appropriation account, but hidden as to amount (if not as to their existence) under some such heading on the left-hand side of the balance sheet as 'Sundry Creditors, and other credit balances' or 'Creditors, including provision for contingencies'. This is no longer permissible under the Companies Act excepting for banks and other exempted Companies.¹

SECRET RESERVES

These have been created freely in the past in the following ways:

- (1) By charging capital expenditure on fixed assets to revenue. This has the effect of understating the value of the fixed asset in the balance sheet. This method is now permissible only for exempted companies.
- (2) By making excessive provision for wear and tear or for the diminution in the value of fixed assets or for bad and doubtful debts, which similarly reduce the balance sheet figures for the relative asset items. Where (as, for instance, in the case of the Bank of England's premises) certain fixed assets were entirely written off out of revenue before 1st July 1948, there is still no regulation obliging a company to disclose the existence of such assets in its balance sheet at all.² This method of creating future secret reserves is still available though it may now be caught by the auditor's duty to certify that the accounts give a true and fair view of the company's

¹ Companies Act, 8th Schedule, Part III.

² Companies Act, 1948, 8th Schedule, para. 5 (1), (a).

position and of the profit or loss for the financial year.¹

- (3) By the undervaluation of stock, work-in-progress and similar circulating assets. As auditors have to accept valuations by the company's officers, this method is still available in practice to all companies.

All these three methods result in the profit and loss balance, if credit, being reduced (if debit, increased) by the corresponding amount. Thus the creation of these secret reserves involves not only a reduction in the book values of certain assets, but also a deliberate understatement of the disclosed profits. It should be noted, however, that in the case of stock undervaluations the profits of the succeeding year will be correspondingly overstated. While the Companies Act has substantially restricted the creation of future secret reserves, it does little to remove or reveal secret reserves set up in the past.

- (4) By the mere appreciation of the real value of a fixed asset over its book value.

Accounting as we know it is based on the assumption – it is now almost a fiction – that all £s are of equal value, the 1900 £ (= 100), the 1913 £ (= 77), the 1938 £ (= 48) and the 1952 £ (= 23), though in fact their approximate relative values in terms of purchasing power are as indicated by the figures in brackets. If a balance sheet item, 'Land and buildings, at cost', comprises properties purchased over the past sixty years, it stands a very good chance of materially understating the real value in present day £s. Even under the quite stringent provisions of the Companies Act, 1948,² which require future purchases to be shown at cost, and all amounts which *in future* are written off for diminution of value to be disclosed in the balance sheet, there is no power to ensure any adjustment either now or in the future, of present understatements of value. This is of course in keeping with the basic accounting principle that no profit should be brought into the accounts until it is actually realized. But the effect is that, in many cases, the fund of assets and

¹ Companies Act, 1948. 9th Schedule.

² *ibid.*, 8th Schedule, para. 5.

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consequently the proprietors' real investment (the net worth) earning a given level of profits, may be many times greater than is disclosed in the balance sheet; a fact which the chairmen of many large undertakings have stressed in their annual addresses to the shareholders when estimating the rate of profit earned on the true (as contrasted with the nominal or the book) amount of the shareholders' total investment.

Example IV

HEADINGS IN TYPICAL BANK ACCOUNTS

(The items which may cover hidden and secret reserves are shown in heavy type)

BALANCE SHEET	
Capital	£
Reserve Fund (including share Premium account)	£
Profit and Loss Account	£
Current, Deposit and other Accounts, including Contingency Accounts	£
(hidden reserve)	
etc. etc. etc.	£££
	£
Cash	£
Call Money	£
Bills	£
Investments at or under market value	£
(Secret reserve types (2), (3) and (4))	
Loans and Advances after deducting Provision for Bad and Doubtful Debts	£
(Secret reserve type (2))	
Trade Investments including Nominee and other Companies (written down to Nil) (Secret reserve types (2) and (4))	£
Other Assets and Accounts (including sundry properties at cost) less amounts written off	£
(Secret reserves types (1), (2) and (4))	
Bank Premises at cost less amounts written off	£
(Secret reserves types (1), (2) and (4))	
etc. etc. etc.	£££
£	£

PROFIT AND LOSS ACCOUNT

Dividend (<i>less</i> tax)	. £	Balance brought forward	£
General Reserve	. £	Profit brought in after providing for taxation on the profits of the year and after making transfers to contingency accounts out of which full provision has been made for any diminution in the value of assets	£
Reserve for future contingencies	. . £		
Balance carried forward	£		
	<hr/> £ <hr/>		<hr/> £ <hr/>

The dictum that 'The whole purpose of a balance sheet is primarily to show that the financial position of the company is at least as good as there stated, not to show that it is, or may not be, better'¹ was seriously challenged by Mr. Justice Wright in the Royal Mail case.² Saying that this dictum had been quoted as a justification for keeping reserves secret, the learned Judge added, 'There may be very great evils if those who . . . control and manage companies for the benefit of shareholders who entrust their money to companies, have very large portions of the company's assets left in the secret disposition of the managing authority. It may work very well in many cases . . . on the other hand it may be the subject of almost intolerable abuse. Such a system may be used to cover up negligences, irregularities and almost breaches of faith.' He was referring to what have here been defined as 'hidden reserves' and the possibility of their misuse to conceal the true trend of profits or losses. These are strong words, and it is not surprising that many eminent accountants deplore the fact that banks and similar institutions are not required to disclose the use of reserves as other companies are.³ The matter was thoroughly thrashed out by the Cohen Committee and the Act does grant substantial exemptions. Accordingly a skeleton bank balance sheet in modern form (Example IV) will provide the best illustration of the hidden and secret reserves and the points where they are concealed.

¹ Buckley, J., in *Newton v. Birmingham Small Arms Co.*, 1906.

² *Rex v. Kylsant*, 1931.

³ Companies Act, 1948. 8th Schedule, para. 7.

Often the only clue to the use of a hidden reserve will be found in some such gratuitous statement in the chairman's speech as 'The fall in the market value of our investments could not be fully met out of the profits of the year and some encroachment on our internal reserves has been unavoidable.' The only indication which, uninformative as it is, can be linked up with this statement is found in the Profit and Loss Account. The contingency account has received a known addition and also unspecified additions made before the profit brought in was struck, and the account has been debited to write down certain unnamed assets by undisclosed amounts, leaving in the contingency account an unrevealed balance hidden in the item 'Current, Deposit and other Accounts'.

It will be clear that the book-keeping entries involved will be identical with those made when disclosed reserves (also on the left-hand side of the balance sheet) are utilized.

The secret reserves, all represented by under valued assets on the right-hand side of the balance sheet, are used differently. For example, if the investments shown in this year's balance sheet at or under market value recover next year the amount by which they were written down this year, they can be written up again by the simple journal entry.

Investments A/c .	. Dr. £100,000
Contingency A/c	. Cr. £100,000

On the wording of the Profit and Loss profit item shown above it would not be possible to bring this £100,000 direct into the year's profit, though a corresponding reduction in the disclosed or undisclosed transfers which would otherwise have been made to contingency account would have the same effect. If the wording of the profit item in the Profit and Loss Account (*vide supra*) were altered to include 'after recrediting provisions no longer required' a direct but still undisclosed re-credit to the Profit and Loss account could be made.

While bank accounts, with which most readers will be familiar, have been taken for the purpose of illustration the lending banker will also be interested in hidden and secret reserves when dealing with borrowing discount and assur-

ance companies and above all in the way in which they can be used to mask the real trend of operating profits. For the general run of companies hidden reserves are no longer possible and the question of secret reserves is merely another aspect of the valuation element in balance sheets, discussed later in this chapter.

BILLS PAYABLE

The presence of this item for any material amount will always put the careful banker on enquiry. Is the use of bills customary in the trade? If the answer is 'Yes', the item may be regarded as on all fours with the other trade creditors. It may be that bills are usual for part of the trading activities, but not for the rest. The proportion of bills payable to open accounts should then be looked into. Where bills are not customary at all, there is a strong suggestion that the bills are mere accommodation paper, often a sign of financial difficulties in the face of which money could be raised only on onerous terms. Any such indication should be followed up by as close investigation as the circumstances of the customer and the interests of the banks require

BILLS RECEIVABLE

On the other hand, an unexplained falling off in the amount of bills receivable, or the absence of the item from the balance sheet of a company in whose business the use of bills is customary¹ is a warning. It may be that the trader is borrowing from tomorrow's collections to meet today's payments, by discounting – sometimes one of the early signs of financial stringency, though often sound business if it enables good discounts for prompt payment to be secured, or borrowings at higher rates of interest to be reduced.

The balance sheet of a company *which is laid before the company in general meeting* would disclose the contingent liability on bills discounted, whether by way of footnote, or otherwise.² But no penalties are imposed if such a footnote be

¹ Manufacturing and wholesale jewellers, opticians and 'furnishers, for instance.

² Companies Act, 1948, Sec. 149: and 8th Schedule, para. 11.

omitted from the copy of the balance sheet furnished by a company to its bankers in connection with an overdraft. Apart from this possibility, where a banker is comparing the figures in the last audited balance sheet with interim current assets figures, the latter will probably not be accompanied by any similar warning note. The only indication of new or increased discounting will then be a fall in the aggregate of debtors and bills receivable out of step with the trend of recent sales, and other related figures.

There is some justification for the view that the worst unsecured lending is to a customer with a fixed and regular income, be he employee or annuitant. If he cannot live on his income this month or quarter, how can he live on the same income during the next period, and, in addition, repay what he overspent in this period? Like all general principles it can quite properly be modified in special cases. Borrowing may be quite justified to enable a salaried man of sound character and thrifty habits to spread a large item of exceptional expenditure over a reasonable period, provided life cover, or its equivalent, is held. But the principle is clear enough; and it applies with equal force to a large company. Borrowing from the future is an expedient to be used with reserve: in any case, while it may be done progressively, it can only be done fully once.

BALANCE SHEET NOTES

The chief items (besides the contingent liability on bills discounted) which must be disclosed in all company balance sheets laid before its general meeting, by footnote or otherwise, are:¹

- (1) Details of arrears of fixed cumulative dividends;
- (2) The existence of any charge on the company's assets to secure the liabilities of third parties;
- (3) Other contingent liabilities; e.g. guarantee liabilities and liabilities under endorsements;
- (4) Liabilities on contracts for capital expenditure.

¹ Companies Act, 1948, Sec. 149: and 8th Schedule, para. 11.

All or any of these may be of vital importance to a lending banker. Unless an authentic copy of the balance sheet, as circulated to the shareholders, is supplied to him, the banker should always bear in mind that there are no penalties laid upon the company or its directors if the copy actually supplied to him fails to comply with the requirements of the Companies Act. For it is doubtful whether such a copy balance sheet could be regarded as 'issued, circulated or published' for the purposes of Sections 155 and 156 of the Act. There would therefore be no obligation for the copy to be signed by the directors or to be accompanied by a profit and loss account, or the auditor's certificate or report. A banker should be especially on his guard against the omission (or suppression) of the latter. In all cases of doubt, the only safe course is to insist on a certificate by the auditors that the balance sheet, profit and loss account and reports supplied, are exactly as required to be laid before the company in general meeting by Section 149 of the Act.

THE VALUATION ELEMENT

It is obvious that assets and liabilities of all kinds, if included in the accounts at all, must be represented in terms of money. This at once introduces the question of valuation. In Example I every one of the items making up the circulating assets represents someone's estimate of value: raw materials, work-in-progress and stock figures are actual valuations; while the value of debtors and bills receivable will have been reviewed to fix amount of provision, if any, necessary for bad debts. The same thing is true of fixed assets which have been adjusted by provisions for depreciation. The proper amount of such provision is a matter of opinion and may quite honestly vary between wide extremes, according to the taste and conviction of the person responsible. The amount of provision may be determined from a revenue angle: that is to say, by estimating the actual loss in value resulting from the year's working, and properly chargeable as an expense. Or an attempt may be made to adjust the book value of an asset to its existing value at the balance sheet date; and existing value itself may be estimated

at the lower of cost or – according to the directors' preference – saleable value, replacement value, or value to the business as a going concern.

Normally the annual provisions for the depreciation of fixed assets can only be settled after forming decisions upon the following points:

- (1) The length of the remaining useful life of the asset;
- (2) Its residual value at the end of that life;
- (3) The appropriate accounting method, e.g. 'straight-line', fixed percentage of diminishing value, or annuity method.

Either of the first two methods is admissible for Income Tax purposes. If it is desired to provide fully for replacement, a further estimate of the cost of replacement at the end of the estimated period, will also have to be made. All or any of these estimates may be falsified in the event.

On the liabilities or 'source' side of the balance sheet, on the other hand practically every item is a record of historic fact, and estimation hardly comes into the picture at all. Apart from the profit and loss balance which, indirectly, rests on many of the estimates referred to above, and probably the provision for taxation, all the liability items shown in Example I record precise facts. But on the assets side it is important to bear in mind always that certain items in every balance sheet represent, not statements of fact, but expressions of opinion. Furthermore, with regard to circulating assets, no inference as to quantities is valid, since the basis of valuation is unknown. Stock is normally valued at the lower of cost or market selling price, but in times of fluctuating prices it is extremely difficult, if not impossible, to apply this cost basis correctly to stock, for the stock will include items bought at all sorts of times and at all sorts of prices. Work-in-progress may be valued at:

- (i) prime cost only,
- or (ii) prime cost, plus estimated proportion of overheads,
- or (iii) prime cost, plus overheads, plus part of the ultimate profit.

In view of the accounting canon that no profit should be brought into the accounts until it is actually earned, method (iii) is only justified in the case of partly completed work under long-term contracts which straddle two or more account years.¹ In such cases, if no credit for part of the profit were taken in intermediate end-account valuations of work-in-progress, no profit at all could be shown for any one contract until the account year in which the contract is actually completed. If his lending is 'near the bone', and the work-in-progress item is of significant size in relation to the total of current assets, the banker will be well advised to make searching enquiries into the basis of valuation adopted.

THE AUDITOR'S REPORT

Under the new Companies Act, auditors are 'placed in a powerful, independent position, free to do their duty fearlessly, without risk of losing their appointment if they resist pressure from the directors of the company upon any occasion when there is a divergence of views between the board and the auditor as to the form of the accounts, or the auditor feels it incumbent upon him to qualify his certificate. This is a fundamental reform of far-reaching consequence'.² Not the least of its effects will be an increasing tendency towards qualified certificates, unless this tendency is cancelled out by an increasing docility in the board room; and careful attention to what the auditor says may, in future, be of immense value to the banker.

It may therefore be even more important in the future than in the past for bankers to insist on seeing the auditor's certificate and/or report, and to be on their guard against any deliberate suppression of adverse comments. The banker should be familiar with the normal form of certificate required by the Companies Act.³ 'Any departure from the orthodox phraseology constitutes a qualification and should be regarded . . . as a danger signal. If the auditor reports that he has been unable to verify the documents of title to invest-

¹ Recommendation X (1), para. 126.

² H. B. Lawson, lecture on 'Banks and the New Companies' Act,' to the Institute of Bankers, March 1948.

³ See Example I, at page 24 *ante*, and Companies Act, 1948, 9th Schedule.

ments or to land and buildings, or that he has not obtained full explanations regarding certain assets, or that he considers the provisions for depreciation inadequate, this denotes that he is dissatisfied on certain points, and the warning should be heeded.¹

Any material questions raised by the auditor's report should be probed fully; for, even with his improved standing, he will only qualify his report as a last resort, after a battle with the directors in which he has failed to secure acceptance of his views.

¹ *Guide to Company Balance Sheets*, Frank H. Jones.

CHAPTER IV

CURRENT ASSETS

Stock, General Considerations – Raw Materials – Work-in-progress
Finished Stock – Debtors.

‘IN the analysis of a borrower’s statement the bank credit man has uppermost in his mind two questions. First, is there a reasonable certainty that the proposed loan will be met at maturity and, second, if unforeseen circumstances should prevent payment at maturity, will the loan be repaid ultimately? An answer to the first and most important question is sought largely in the relation of the borrower’s quick assets to his current liabilities; an answer to the second in the relation of his slow or permanent assets to his permanent liabilities. . . . Current liabilities must be met out of quick assets; permanent liabilities should be offset by slow or permanent assets.’¹

In modern banking practice there has been a marked shift in emphasis from break-up value of fixed assets to ‘going-concern’ value. Discussing accountancy trends in the U.S.A. which have been accelerated by changes in bankruptcy laws, one writer has said ‘The grantor of credit in the past was chiefly interested in what has been graphically called the “pounce” value. He was not greatly concerned with the basis on which fixed assets were carried (in the accounts), since their value in case of default would have to be appraised in an entirely different way. He was, however, insistent that current assets, such as inventories, should be conservatively stated, and his support had much to do with the general adherence to the rule that inventories should be taken at cost or market, whichever is the lower . . . changes in bankruptcy law, designed to facilitate reorganization . . . have restricted the right to “pounce”, and shifted the emphasis from salvage to earning capacity. . . .’²

The lending banker is now vitally interested in, the current

¹ *Bank Credit*, C. A. Phillips.

² *Financial Accounting*, 1943, George O. May.

position not in relation to break-up, but because he wishes to be assured that his advance can be serviced, reduced and finally repaid, and in the normal course of business the current assets alone can satisfy these requirements.

It may, therefore, be profitable to consider the main circulating assets in some detail. They are:

(a) STOCK – under the three sub-headings:

- (i) Raw Materials;
- (ii) Work-in-progress;
- (iii) Finished Stock.

(b) DEBTORS

Their quality in the sense of their cash producing potential is even more important than the book figure. Stock and debtors will not discharge day-to-day liabilities until turned into cash.

STOCK GENERALLY

A lending banker must be on his guard against omnibus items such as 'Stock and Work-in-progress', or 'Stocks of Raw Materials and Finished Goods', or, perhaps worst of all because it merges two different kinds of asset, 'Debtors and Work-in-progress'. According to the nature of the business separate figures should be insisted on where appropriate for:

- (a) Raw Materials;
- (b) Works sundries – Oil, fuel, etc.;
- (c) Bought-in Components;
- (d) Work-in-progress;
- (e) Completed and saleable Stock;
- (f) Crates, containers and packaging materials;
- (g) By-products.

It should always be borne in mind that the inventory gives great scope for 'imagination', and it is just at this point where it is most required that the protection of an auditor's certificate is of least value. For the auditor is not an appraiser and in the final accounts, as in the interim figures, must accept both the taking and valuing of stock of all kinds by the

company's experts. This is particularly true where work-in-progress is concerned. The auditor may advise as to the proper basis of valuation, but is powerless to ensure that his advice is in fact followed. Where full stock accounts are kept, reinforced by a system of regular internal checks, the position may be a little more satisfactory. Generally, however, a banker is very much in his customer's hands as far as stock figures are concerned, and here the question of character and integrity is of the highest importance. If a real check is considered essential in a particular case, it is a job for an expert in that particular line of business; in cases of real doubt a banker should not hesitate to put in his own nominee to investigate and report.

Special attention should be paid to the valuation of stock which has been acquired by 'trading-in' – for example, second-hand cars which have been taken in part payment for new ones – often brought into the accounts at the figure allowed to the customer, as being the 'cost' price. This cost figure is obviously an arbitrary one and may have no relation to the true figure which should be re-assessed in the light of market conditions. This error is perhaps more likely to occur in interim figures than in the annual stock-taking at the end of the account year, but is no less dangerous on that account.

Particularly in connection with interim figures, but at other times as well, attention should also be paid to fashion goods, which, if they miss their market, may be almost valueless; to lines which are hanging fire perhaps in the face of the competition of a superior product; to special lines such as cheap Government surplus which the trader may be tempted to write up to a figure based on current prices (thus improperly anticipating a profit yet to be earned): and to by-products, which may have been valued at expected selling price in a market which no longer exists.

Finally the banker should satisfy himself (and in so doing help to protect his customer's interests as well) that all stock is fully covered by insurance against fire, burglary, flood and other risks appropriate to its nature. It is the easiest thing in the world for a busy trader to overlook this essential protection: and so many, even in a large way of business, fail to realize the impact of an average clause if they are under-insured and

suffer only a partial loss.¹ A Loss of Profits (or Consequential Loss) Policy is also a useful safeguard against loss of earnings during the period of dislocation which will follow a serious fire, or other hazard for which such cover is available.

Stock: (1) Raw materials.

This item appears only in the accounts of manufacturing and processing concerns. The end product of one industry will often be the raw material of another.² It may vary from a basic raw material like raw cotton to highly specialized bought-in components. Most basic raw materials will readily find a buyer, but specialized components are often completely valueless except to the business and for the product for which they were designed. Before therefore an estimate can be formed by a banker of either the absorbability into normal production of raw materials, or of their saleability, he must know the business. Absorbability involves consideration of the ease with which the materials can be processed or incorporated into finished stock: anything from simple assembly to the most intricate operations may be involved. Familiarity with the processes of manufacture is accordingly very material in measuring the risks that the channels of normal production may be clogged. Where several types of materials or components have to be incorporated into the final product, the shortage of only one item may for a time 'freeze' all the remaining stocks of raw materials, as well as a large amount of work-in-progress.

Stock: (2) Work-in-progress.

This type of stock wants especially close watching. If it is larger in relation to the other circulating assets than previous records of the same business and of similar businesses have shown to be normal, bottle-necks, or other important diffi-

¹ The average clause provides that where property is insured for less than its true value, the insured and the insurance company shall share all losses, total or partial, in the same proportion that the sum insured bears to the value of the property. If property valued at £1,000 is insured for only £750, the owner is deemed to be carrying a quarter of the risk himself. When loss or damage to the value of, e.g. £400 is sustained, the insurer will be liable to pay £300 only.

² For example, cloth is the weaver's finished product, but the maker-up's raw material.

culties affecting production may be suspected, and the matter should be fully probed. An excessive figure for work-in-progress indicates serious clogging in the circulation which is detrimental to the health and efficiency of the business as a living organism. On the other hand, when it is necessary to put in a receiver to turn work-in-progress into cash, 'the credit man must always face the fact that unfinished goods require . . . heavy expenditure under unfavourable conditions preparatory to marketing.'¹ Amongst such unfavourable conditions is the possibility, and in some cases the probability, of having to complete the assembly or processing with labour unskilled in the work (and therefore uneconomic), because the existing team has dispersed.

Where, as is frequently the case, progress payments are received, work-in-progress figures should always be quoted in the balance sheet thus:

	£	£
Work-in-progress, as valued by the Managing Director	17,500	
Less Amounts received on account .	10,000	
	<hr/>	7,500

The quoting of work in-progress at £17,500 and the inclusion of the £10,000 with other creditors would be open to the following objections:

- (1) 'The total of effective current assets would be overstated by £10,000 – a very material thing where a banker is lending against current assets under monthly or quarterly certificates.
- (2) The total creditors would be similarly overstated: the £10,000 will not, like other creditors, have to be paid out by the company in cash, unless the company falls down on the contract or, in special cases, refunds are due.
- (3) The proper relationship between current assets and current liabilities will be distorted. .

¹ *Bank Credit*, C. A. Phillips.

Stock: (3) Finished Stock.

This may be difficult to sell when the banker has 'pounced': and the more specialized the product, the greater the difficulty. It may well be that for an exclusive commodity, a separate selling organization has had to be created. If this has broken up before the receiver is in the saddle, his task will be unenviable indeed: low prices and high expenses are to be expected. Moreover, the time factor is important. 'The sale of stocks of merchandise at prices that will cause anything short of the slaughter of the interests of the merchant or banker . . . requires considerable time. The failure of a merchant to pay 100 cents (to the dollar) may be due in large measure to bankers clamoring for a settlement and forcing a quick sale of goods in bulk. A merchant . . . bought the stock of a bankrupt concern . . . and cleared \$100,000 in ten months. The creditors were banks impatient for settlement. They got it reasonably quick and unreasonably small!'¹

Any excessive accumulation of stocks must be regarded as a danger signal. It probably means that demand has fallen off and sales have dwindled: or that requirements have been overestimated and the business is overstocked. Stock-in-trade will not pay pressing debts. If cash is urgently required, therefore, sales must be forced by reducing prices, perhaps drastically. Where the stock is held subject to agreement not to retail below a stipulated price for a stated period,² the position of an overstocked trader is unhappy indeed. The following figures indicate the effect of successive additions of £5,000 of stock bought on credit, and shows the percentage of the book valuation of stock which must be realized on break-up to satisfy the creditors; a 100% collection of debtors is assumed.

In actual liquidation it might be possible to realize stock at 22% (a) of its book value; or even 55% (b) under favourable conditions: but it would be a very optimistic liquidator or receiver who expected to collect 68% or 75%, *after allowing for the expenses of realization*.

¹ *Bank Credit*, C. A. Phillips.

² An example is the book publishing and book selling trade. Innumerable proprietary articles are sold subject to a similar limited licence.

Example V

(a) Creditors £5,000	Cash	£ 500	£
	Debtors	3,000	
		<hr/>	3,500
	Stock at cost £7,000 must produce		1,500 = 21.4%
			<hr/>
			£5,000
(b) Creditors £10,000	Cash and Debtors	3,500	
	Stock £12,000 must produce	6,500 = 54.2%	
		<hr/>	£10,000
			<hr/>
(c) Creditors £15,000	Cash and Debtors	3,500	
	Stock £17,000 must produce	11,500 = 67.6%	
		<hr/>	£15,000
			<hr/>
(d) Creditors £20,000	Cash and Debtors	3,500	
	Stock £22,000 must produce	16,500 = 75%	
		<hr/>	£20,000
			<hr/>

DEBTORS

The term is used here to include normal trade debtors, whether on open account or represented by bills receivable. The usually insignificant amounts representing deposits and payments in advance may be ignored for our present purpose, as they will not produce any future inflow of cash while the business is in being, and very little if it is wound up. In a business which sells wholly on credit, debtors is the only current asset which actually produces cash, and in most businesses is the source of the bulk of the cash receipts (though a cash retail business is an obvious exception). It is this fact which has induced some writers to classify debtors as a liquid asset.

In the building and similar trades it is not unusual for contracts to provide for retentions up to as high as 25% of the contract price, deductible *pro rata* from interim payments, and retainable by the builder's customer for three to twelve months after completion. This is to meet counter-claims, or to cover latent defects which may appear after the work is finished: the retentions will usually be lost if, for any

reason, the work is not completed at all. Retention moneys being thus vulnerable in many ways, the prudent banker will deduct the amount retained from the debtors figure in estimating the value of current assets. The clogging effect of retentions upon the inflow of cash will be obvious.

It may not be out of place to add here that Local Authorities and Government Departments often require indemnity bonds for perhaps 10% or 15% of the amount of the contract from the contractor's banker, or other surety of standing. If the contractor falls down on his contract he may not only lose his retention moneys, but also have to face a claim from the surety under the usual counter-indemnity. This will certainly arise if the retentions are insufficient to pay some other contractor to complete the work.

To the extent of retentions at any rate, debtors cannot be regarded as a liquid asset: and its liquidity will often vary seasonally and geographically in different industries and trades, and even in the same business. For example, the book debts of an agricultural engineer or merchant will be very much more liquid in November than in April: and if a tradesman cannot collect the amounts due from his seaside hotel and boarding-house customers before October, he will probably have to wait until the following summer. The flow of book debts is extremely sensitive to changes in general financial conditions. Often one of the first signs of tightness of money is not a falling off in retail sales, but an increase in debtors, accompanied by a slowing down in collections. The increase in debtors in such circumstances is, of course, due to the switch-over of certain buyers from cash purchase to credit purchase. It is obvious that when an inflow of cash is most essential, the collection of debtors is generally most difficult: and when times are bad, book debts are anything but liquid. It is true that certain financial houses are prepared to purchase book debts, though only after minute investigation and at a discount large enough to cover the risk and yield a profit. But this is a desperate and expensive method of clothing debtors with liquidity, and merely emphasizes, that normally they are not liquid in the true sense of the word.

It may be appropriate here to sound a note of warning

regarding the possible existence of trading set-offs. Where the same person appears both in the bought ledger and the sold ledger of the same business, e.g.

Creditors include

Merchants Supplies Ltd. £10,000

Debtors include

Merchants Supplies Ltd. £30,000

the debtors figure against which the holder of a floating charge is lending may be overstated by £10,000 if a true legal set-off exists. If the lending banker relies on the full £30,000, he will be disappointed to find that only £20,000 can be collected by his receiver. The undisclosed creditor for £10,000, previously regarded as unsecured, will thus, in effect, rank as preferential in front of the bank's floating charge.

There is a further danger that debtors may not be well spread. Where a large amount appears against one name, or as due from a subsidiary company (as a separate entry in the balance sheet), enquiry should be made as to whether the debt is 100% good.

With these two points in mind the banker's prudence will, in suitable cases, suggest calling periodically for full lists of both debtors and creditors.

CHAPTER V

WORKING CAPITAL

A Business in Slow Motion – Circulation of Assets – Working Capital Reconciliation – Estimating Current Profit – Factors Affecting Working Capital – Importance of Current Assets Make-up.

CIRCULATING capital is aptly so-called because, in the normal process of daily business, it circulates; and working capital, as it works, changes in make-up and amount. It will be instructive to follow such changes during the first nine weeks' operations of an imaginary manufacturing company. The figures given have no pretensions to probability in a real business, but will help to demonstrate 'how the wheels go round'.

Example VI

Start (1st January, 1945)

(a) Capital	.	.	£2,000	Cash	.	.	.	£2,000
			<u> </u>					<u> </u>
(b) Capital	.	.	2,000	Fixed Assets	.	.	.	1,000
				Cash	.	.	.	1,000
			<u> </u>					<u> </u>
			£2,000					£2,000
			<u> </u>					<u> </u>

1st WEEK. *Wages paid* £200: *Materials bought on credit* £280: *Power, etc., on credit* £30: *Overheads* £30 cash, £70 on credit: *materials consumed* £140: *Production (all unfinished work)* £370.

End-week Balance Sheet

	£		£
Capital.	2,000	Fixed Assets	1,000
Trade Creditors	280	Materials	140
Expense Creditors	100	Work-in-progress	370
		Cash	770
		Profit and Loss Account	100
	<u> </u>		<u> </u>
	£2,380		£2,380
	<u> </u>		<u> </u>

WORKING CAPITAL, £900.

Note: In this, and the following eight weekly balance sheets the fixed, and all the circulating assets are brought in at prime cost.

There has been a considerable change in the make-up of the current assets, which have increased along with the current liabilities. Working capital has fallen by the amount of the loss (overheads £100).

2nd WEEK. *Wages £200: materials bought on credit £70: works expenses on credit £30: overheads £30 cash, £70 credit: materials consumed £70: production £300.*

Balance Sheet

	£		£
Capital.	2,000	Fixed Assets	1,000
Trade Creditors	350	Materials	140
Expense Creditors	200	Work-in-progress	550
		Finished Stock	120
		Cash	540
		Profit and Loss Account	200
	<hr/>		<hr/>
	£2,550		£2,550
	<hr/>		<hr/>

WORKING CAPITAL, £800.

3rd WEEK. *All items as second week, AND sale on credit for £500 of goods costing £250 to produce.*

Balance Sheet

	£		£
Capital.	2,000	Fixed Assets	1,000
Trade Creditors	420	Materials	140
Expense Creditors	300	Work-in-progress	450
		Stock	270
		Debtors	500
		Cash	310
		Profit and Loss Account	50
	<hr/>		<hr/>
	£2,720		£2,720
	<hr/>		<hr/>

WORKING CAPITAL, £950.

In this week we have finished with merely exchanging certain assets for others of equal aggregate value, or acquiring assets and compensating liabilities, and have, for the first time, exchanged an asset stock, £250, for another asset, Debtors, of greater value, *viz.* £500, and the element of profit, £250, is for the first time introduced. Exactly the same result would have followed had all or any of the £500 sales been for cash; the aggregate of debtors and cash would have been the same. Working capital has been increased by the amount of the selling profit, £250, less £100 overheads.

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4th WEEK. *As 2nd week, AND stock costing £280 sold for £560.*

Balance Sheet

	£		£
Capital.	2,000	Fixed Assets	1,000
Trade Creditors	490	Materials	140
Expense Creditors	400	Work-in-progress	400
Profit and Loss Account	130	Stock	340
		Debtors	1,060
		Cash	80
	<u>£3,020</u>		<u>£3,020</u>

WORKING CAPITAL, £1,130.

As a result of further profitable sales, the adverse balance on the Profit and Loss Account has been converted into a credit balance. The balance sheet totals continue to grow.

5th WEEK. *As 2nd week, AND stock costing £310 sold for £620: 1st week's creditors £380 paid: £500 borrowed on a debenture.*

Balance Sheet

	£		£
Capital.	2,000	Fixed Assets	1,000
Debenture	500	Materials	140
Trade Creditors	280	Work-in-progress	350
Expense Creditors	400	Stock	380
Bank Overdraft	30	Debtors	1,680
Profit and Loss Account	340		
	<u>£3,550</u>		<u>£3,550</u>

WORKING CAPITAL, £1,840.

The working capital has been increased by a further week's net profit, £210, and also by the long-term loan of £500. The latter has increased the current assets (cash) without increasing the *current* liabilities. In spite of the substantial net profit made, and the 84% increase in working capital, compared with the start (b), a very unliquid position has developed, necessitating a temporary borrowing from the bank. With creditors at £680 only, debtors at £1,680 and other current assets at £870, any banker would regard £30 unsecured for a short period as free from risk: he would note that the in-flow from debtor collections is imminent.

6th WEEK. *As 2nd week, AND stock costing £350 sold for £700; 3rd week's sales £500 collected: 2nd week's creditors £170 paid.*

Balance Sheet

	£		£
Capital.	2,000	Fixed Assets	1,000
Debenture	500	Materials	140
Trade Creditors	280	Work-in-progress	400
Expense Creditors	400	Stock	280
Profit and Loss Account	590	Debtors	1,880
		Cash	70
	<u>£3,770</u>		<u>£3,770</u>

WORKING CAPITAL, £2,090.

With debtors now being collected the business may be said to have reached normal working during this week. The cash position has been improved accordingly.

7th WEEK. *As 2nd week, AND stock costing £300 sold for £600: 4th week's sales £560 collected: 3rd week's creditors £170 paid.*

Balance Sheet

	£		£
Capital.	2,000	Fixed Assets	1,000
Debenture	500	Materials	140
Trade Creditors	280	Work-in-progress	400
Expense Creditors	400	Stock	280
Profit and Loss Account	790	Debtors	1,920
		Cash	230
	<u>£3,970</u>		<u>£3,970</u>

WORKING CAPITAL, £2,290.

8th WEEK. *As 2nd week, AND stock costing £340 sold for £680: 4th week's creditors £170 paid: 5th week's sales £560 collected: new machinery bought £400.*

Balance Sheet

	£		£
Capital.	2,000	Fixed Assets	1,400
Debenture	500	Materials	140
Trade Creditors	280	Work-in-progress	380
Expense Creditors	400	Stock	260
Bank Overdraft	10	Debtors	2,040
Profit and Loss Account	1,030		
	<u>£4,220</u>		<u>£4,220</u>

WORKING CAPITAL, £2,130.

Working capital has been increased by the week's net profit £240 and decreased by the purchase of fixed assets for £400: recourse to the bank is again necessary.

Example VII

TRADING ACCOUNT, 9 weeks ended 3rd March 1948

Purchases	£ 840	Sales	£ 4,320
Less closing stock materials	140		
Materials used	700		
Wages	1,800		
Works expenses	270		
Cost of production	2,770		
Less Work-in-progress	420		
Cost of finished goods	2,350		
Less closing stock	190		
Cost of goods sold	2,160		
Gross Profit (50%)	2,160		
	£4,320		£4,320
PROFIT AND LOSS ACCOUNT			
Overheads	900	Gross Profit	2,160
Directors' Fees	100		
Depreciation	225		
Debtenture Interest	10		
Net Profit	925		
	£2,160		£2,160
APPROPRIATION ACCOUNT			
Provision for Taxation	390	Net Profit for	
Balance	535	period	925
	£925		£925

BALANCE SHEET as at 3rd March 1948
(After adjustments)

Fixed Assets at cost	£ 1,400		
Less Depreciation	225		
Less Loan, secured by Debenture	1,175		
	500		
NET FIXED ASSETS			675
CURRENT ASSETS:			
Raw Materials	140		
Work-in-progress	420		
Stock	190		
Debtors	2,000		
Total circulating assets	2,750		
Cash in hand	190		
	2,940		
Less Current Liabilities:			
Trade Creditors	280		
Expense Creditors	400		
Provisions:			
Taxation	390		
Debtenture interest	10		
	400		
	1,080		
WORKING CAPITAL			1,860
TOTAL NET ASSETS			£2,535
Represented by			
Capital			2,000
Balance of Profit and Loss Account			535
			£2,535

9th WEEK. *As 2nd week, AND stock costing £330 sold for £660: 5th week's creditors paid: 6th week's sales £700 collected.*

Balance Sheet

£		£	
Capital.	2,000	Fixed Assets	1,400
Debenture	500	Materials	140
Trade Creditors	280	Work-in-progress	420
Expense Creditors	400	Stock	190
Profit and Loss Account	1,260	Debtors	2,000
		Cash	290
	<hr/>		<hr/>
	£4,440		£4,440
	<hr/>		<hr/>

WORKING CAPITAL, £2,360.

The Directors now decide to close the accounts after:

- (i) providing £225 for depreciation of fixed assets,
- (ii) paying £100 Directors' fees in cash,
- (iii) providing £390 for taxation,
- (iv) providing £10 for accrued debenture interest.

The resulting final accounts are set out on the opposite page. The business has been running soundly and successfully. The frequent balance sheets make it possible to see the action of the business in slow motion, and we have already quite unconsciously fallen into the way of picking out changes in the individual balance sheet items and considering how they have come about: this is always one of the most profitable ways of extracting information from a balance sheet. The following points are deserving of special notice:

- (1) In the nine weeks the bank account has swung from Cr. £1,000 at the start (b), to overdraft £30 (week 5), finally closing at Cr. £190. A vigorous swing in the bank account is a very desirable thing, and should always be looked for. The banker is in a specially favourable position for watching this important aspect of his customer's business;
- (2) The initial working capital was barely enough to see the business through to satisfactory production; but had half the sales been for cash, the bank balance would never have fallen below £560; and £500

initial working capital would have sufficed without recourse to the bank;

- (3) Although progressive profits were made after the 2nd week, at no time were they realized *in cash*, but represented by a mixture of current assets, with debtors predominating (4th week onwards). The company is carrying forward undistributed profits of £535, but, at the final balance sheet date the cash in hand was £190 only;
- (4) The changes in the make-up of the current assets illustrate the extraordinarily fluid nature of a business, and emphasize the danger of relying on balance sheets which are months or even (in these days of overworked accountants and staff shortages) a year or more old. The percentage analysis set out below shows how rapidly the current asset position can change in the ordinary course of business, even from week to week.

Example VIII

	PERCENTAGE ANALYSIS OF CURRENT ASSETS										
	End of Week										
	Start (b)	1	2	3	4	5	6	7	8	9	
Materials. .	--	% 11	% 10	% 8	% 7	% 5	% 5	% 5	% 5	% 5	
Work-in-progress	—	29	41	27	20	14	14	13	14	14	
Stock . .	—	—	9	16	17	15	10	9	9	6	
Debtors . .	—	—	—	30	52	66	68	65	72	66	
Cash . .	100	60	40	19	4	—	3	8	—	9	
Total Current Assets	% £	100 1,000	100 1,280	100 1,350	100 1,670	100 2,020	100 1,550	100 2,770	100 2,970	100 2,820	100 3,040

It will also be profitable to extract a reconciliation statement showing how the changes in the amount of working capital during the nine-week period were brought about:

Opening working capital (Start (b))	£	£
ADD Net profit after tax provision	535	1,000
¹ Depreciation	225	
Loan	500	
	<hr/>	1,260
		2,260
DEDUCT Capital expenditure		500
		<hr/>
Closing working capital, as per final balance sheet	£1,760	

The bearing of this analysis in a banker's control of a balance sheet advance will be clear from the following calculation, based on the same figures. It is assumed that he is supplied with periodical figures of current assets and current liabilities.

Example IX

1st January

Working Capital £1,000

5th March (Interim figures, *not* final balance sheet):

Creditors		Current Assets	
	£		£
Trade	280	Materials	140
Expense	400	Work-in-progress	420
	<hr/>	Stock	190
£680		Debtors	2,000
	<hr/>	Cash	290
			<hr/>
			£3,040
		DEDUCT Creditors	680
			<hr/>
		Working Capital	£2,360
			<hr/>
		Increase in working capital	£1,360
Adjust for non-revenue items:			
ADD Capital Expenditure			400
			<hr/>
			1,760
		DEDUCT Loan raised	500
			<hr/>
Increase in working capital, attributable to PROFIT for the period			£1,260

¹ Depreciation has to be added back to the net profit figure because it did not involve a cash disbursement, nor any other diminution of current assets. As previously explained at page 39 *ante*, a provision for the depreciation of fixed assets merely reduces by the identical amount (a) net worth and (b) fixed assets.

Such profit will, of course, be subject to provisions for taxation, and depreciation, and also for accrued expenses which may not have been recorded in the books, as for instance, directors' fees and debenture interest. Where such amounts are likely to be material, a notional figure based upon the last audited accounts can be deducted. In any case the profit figure so deduced is only an approximation. It is, however, invaluable as an up-to-date indication of current trends, and its ascertainment requires only details of current assets and liabilities, and of *non-revenue* receipts and payments for the period since the last figures were furnished.

The surprisingly few ways in which the amount of the working capital can be increased or decreased are tabulated below for convenience of reference.

FLUCTUATIONS IN WORKING CAPITAL

	INCREASES	DECREASES
CASH TRANSACTIONS	Fresh Capital raised. Long-term borrowing. Sale of fixed assets.	Capital repaid. Loans repaid, or made. Purchase of fixed assets. Dividends, drawings and taxation.
CREDIT TRANSACTIONS	Sale of fixed assets on credit.	Purchase on fixed assets on credit. Provisions for dividends and <i>current</i> taxation.
PROFIT AND LOSS	Undistributed net profits (adding back depreciation of <i>fixed</i> assets). ¹ Profits represented by increased circulating assets or liquid assets or decreased current liabilities in any combination.	Net losses (deducting depreciation of <i>fixed</i> assets). ¹ Losses represented by reduced circulating assets or liquid assets or increased current liabilities in any combination.
¹ Though cash must be found to pay dividends or taxation, profits will not necessarily be represented by increased cash; nor will losses necessarily be accompanied by a fall in cash.		

The make-up of working capital is not less important than its amount. The point is well brought out by the following analysis of the working capital shown in three consecutive balance sheets of 'Manufacturers Limited'.

Example X

‘MANUFACTURERS LIMITED’
ANALYSIS OF WORKING CAPITAL POSITION
31st March
(£000's omitted)

	1946	1947	1948
	£	£	£
Current Assets:			
Raw Materials	5	10	10
Work-in-progress	7.5	15	50
Stock	20	40	50
Debtors	24.5	17	17
Bills Receivable	2.5	5	—
Liquid Assets	17.5	10	—
	<hr/>	<hr/>	<hr/>
TOTAL	77	97	127
Current Liabilities	22	42	72
(Details below)			
	<hr/>	<hr/>	<hr/>
WORKING CAPITAL	£55	£55	£55
	<hr/>	<hr/>	<hr/>
Current Liabilities:			
Trade Creditors	5	17	43
Bank Overdraft	—	—	5
Taxation provision	12	10	14
Proposed Dividend	5	15	10
	<hr/>	<hr/>	<hr/>
	£22	£42	£72
	<hr/>	<hr/>	<hr/>

The following points should be noted:

- (1) The working capital is the same in each case.

Possible explanations:

- (i) No profits have been earned;
 - (ii) Profits have been earned and paid away, or expended on fixed assets, etc.;
 - (iii) Losses have been sustained, but made good by non-revenue receipts;
- (2) Debtors have not moved in step with stock and work-in-progress, which suggests that there has been over-production and a fall in sales;
- (3) Creditors have increased faster than debtors;
- (4) Liquid assets have disappeared;
- (5) Bills receivable have disappeared. Discounted?
- (6) Had the business been closed down on the balance date in

- (i) 1946, the creditors could have been met from liquid assets and only 8% of debtors;
- (ii) 1947, the liquid assets and all the debtors were insufficient, and 25 % of the stock would have to be realized at book value to clear the creditors;
- (iii) 1948, creditors exceeded the whole of the debtors and finished stock, and recourse to raw materials and/or work-in-progress would have been necessary.

Numbers 2 to 6 inclusive are consistent with progressive overtrading, a subject which will be examined fully at a later stage in this book. It will suffice at this point if it is realized that the make-up of current assets and their cash-producing potential is what really matters in a going concern. The quality of the individual items, discussed in the previous chapter, is therefore vital.

CHAPTER VI

REVENUE ACCOUNTS

Revenue Accounts – Percentage Revenue Accounts – The relation between Revenue Accounts and the Balance Sheet.

REVENUE ACCOUNTS

HITHERTO consideration has been given to the balance sheet alone; but no reader with a working knowledge of accounts will need to be reminded that a balance sheet by itself can give only limited information, valuable though it may be. To shed fuller light on the state of any undertaking the balance sheet must be read in conjunction with the revenue accounts.

To illustrate this, two widely differing, but quite possible, sets of Revenue accounts of 'Manufacturers Limited' – *A* and *B* – are given for the year ended 31st March 1946, to be read in conjunction with the balance sheet at that date, which has already been discussed and analysed in Chapter II (Example I). As far as form is concerned, it will be noticed that a separate manufacturing profit is shown – always an advantage where a selling price can be determined based on actual sales or comparisons with similar products dealt with in the open market. In the absence of such price, the less useful alternative is to incorporate the manufacturing cost of the finished production as a credit to the manufacturing account, the same figure being debited as a quasi-purchase in the trading account. The gross selling profit will then include, for at least part of the goods handled, both manufacturing and merchanting profit. In the present instance the method actually adopted is doubly desirable, because the company also sells bought-in goods. In such a case the inclusion of certain purchases at manufacturing cost and others at wholesale prices, in proportions which may obviously vary from time to time, might well invalidate any comparisons of the gross profit rate from year to year.

Much more important than the form, however, is the fact

REVENUE ACCOUNTS

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PROFIT AND LOSS ACCOUNT

	A	B		A	B
	£	£		£	£
Debtenture Interest (Gross)	3,500	3,500	Factory Profit	46,000	7,000
Directors' Fees	5,000	50,000 ¹	Trading Profit	51,000	140,000
Overheads	10,000	20,000	Sundry Receipts	1,500	—
Provision for Depreciation	23,400	23,400			
Net Profit	56,600	50,100			
	<u>£98,500</u>	<u>£147,000</u>		<u>£98,500</u>	<u>£147,000</u>

APPROPRIATION ACCOUNT

	A	B		A	B
	£	£		£	£
Balance forward from last year	—	15,100	Balance forward from last year	13,400	—
Provision for Taxation	35,000	20,000	Profit for the year	56,600	50,100
Interim Dividend Paid	20,000	—			
Provision for Final Dividend	5,000	5,000			
Balance	10,000	10,000			
	<u>£70,000</u>	<u>£50,100</u>		<u>£70,000</u>	<u>£50,100¹</u>

¹ This figure for directors' drawings is, of course, highly improbable, but has been included expressly to illustrate that such an undesirable depletion of working capital could not have been discovered from the balance sheet alone — or even suspected.

that such varying financial and trading operations could have led to an identical balance sheet at the end of the year. In the *A* accounts both Manufacturing and Trading rates of gross profit are satisfactory at 46.5 % and 24 % respectively. The *B* accounts show only a negligible manufacturing profit (5.5 %) and the bulk of the profit shown was earned in the merchanting department (29 % of sales). *B* sales are more than double *A* and carry a far higher merchanting ingredient. Moreover, the March 1946 balance sheet alone gives no inkling of the fact revealed by the *B* appropriation account that in the past losses have been made. The low tax provision in the *B* accounts is either inadequate in itself or, if correct, indicates that there are substantial past losses brought forward in the tax computation, to offset a large part of the current year's profit. There is no need to labour the obvious. Clearly the balance sheet must be read with the Revenue account if the undertaking is to be seen in its true light. It is to be greatly regretted therefore that where a holding company issues with its own balance sheet a consolidated balance sheet and a consolidated profit and loss account, it is not required by the Companies Act, 1948,¹ to issue at the same time its own profit and loss account. The banker should call for this if the printed accounts do not give him all the information he requires.

The differences between the two sets of Revenue account will be brought out further when we consider the Balance Sheet/Revenue relationship discussed later in this chapter.

The value of a percentage balance sheet has already been noted.² It is also illuminating to set out a Trading and Profit and Loss Account reduced to percentages of sales, Example XII.

It may certainly be useful for the banker and the business man to know that for every £100 of sales (Account *A*)

£15/0/0 goes in handling expenses;
 £1/10/0 in mortgage interest;
 £4/10/0 in overheads,

and so on.

But it will not be overlooked that variations in individual Profit and Loss percentages from year to year may be the

¹ Sec. 149.

² Example III at page 30.

Example XII

'MANUFACTURERS LIMITED'

TRADING ACCOUNT FOR THE YEAR ENDED 31ST MARCH 1946

	A	B		A	B
Cost of goods sold	61%	65%	Sales	100%	100%
Expenses . . .	15%	6%			
Gross Profit . .	24%	29%			
	<u>100%</u>	<u>100%</u>		<u>100%</u>	<u>100%</u>

PROFIT AND LOSS ACCOUNT

Debenture Interest .	1.5	.7	Trading Profit .	24	29
Directors' fees . .	2.5	10.4	Manufacturing		
Overheads . . .	4.5	4.1	Profit . . .	22	1.4
Net Profit . . .	37.5	15.2			
	<u>46</u>	<u>30.4</u>		<u>46</u>	<u>30.4</u>

result of changes in overhead expenses with a constant level of sales; of constant overheads with a change in total sales; or of a combination of both factors. Clearly, however, if sales fluctuate widely from year to year certain percentage figures in the Profit and Loss Account, calculated with reference to the changing amount of sales to which they have no direct relation, can be downright misleading, and year to year comparisons may be meaningless. Usually a direct comparison between the actual Profit and Loss figures is simpler and more reliable.

But when we have studied our revenue accounts and compared this figure with that, what does it all add up to? How much have we learnt about what actually happened in the business during the period covered by the accounts? What is the reality behind the figures? A simple illustration will supply part of the answer.

Suppose we are told that a schoolboy leaves his home at 8.45 and reaches the school, a mile away, just in time to beat the bell at 9.15. What can we safely infer regarding his mode of progress? Any of the following things may have happened:

- (1) He may have strolled at a steady two miles an hour;
- (2) He may have started off at a brisk trot and then stopped for breath before approaching the school gates at a sedate walk;

- (3) He may have set out at a normal pace as far as the cycle shop and have remained there with a covetous nose flattened against the window, dallying so long that he had to do even time to the school;
- (4) Or he may have lost time by returning home for his forgotten homework, making it necessary for him to run hard all the way to school in the last few minutes.

Change the time from half an hour to a whole year and substitute a live business for an irresponsible schoolboy: will your revenue accounts tell you any more about set-backs, changes of pace, the early spurt and the slow finish, than the bare statement that our schoolboy took half an hour to get to school? In a Trading Account or a Profit and Loss Account 'the condensing of a year's transactions has the merit of simplicity but it effectively hides all the price and sales trends of the period'.¹ No indication will be given of seasonal fluctuations; of good selling lines and bad; of progress or recession in different areas and at different times; nor of any changes in rates of gross profit on different articles, or their causes.

The following example shows the trading accounts, for two consecutive years, of a business which retails one article only:

Example XIII

	YEAR I	YEAR II
	£	£
Opening Stock . . .	672	672
Purchases . . .	4,704	6,670
	<hr/>	<hr/>
Less Closing Stock . .	5,376	7,342
	672	1,764
	<hr/>	<hr/>
Cost of Sales . . .	4,704	5,578
Gross Profit . . . 33½%	2,352	30% 2,392
	<hr/>	<hr/>
TOTAL SALES . . .	£7,056	£7,970
	<hr/>	<hr/>

What does comparison of these two trading accounts tell us?

- (1) The Sales are up by 11.3%,
- (2) Purchases are up by 42%,

¹ *The Principles and Interpretation of Accounts*, H. L. Ellis.

- (3) Rate of gross profit is down from $33\frac{1}{3}\%$ to 30% and – most significant of all –
- (4) The value of the stock on hand at the end of Year II is 2.6 times that at the end of Year I.

The last point may mean that business is booming and every available penny has been put into increased stocks in anticipation of harder prices and bigger profits. It may equally mean that severe consumer resistance has developed and sales have fallen off unexpectedly in the latter part of the year. A look at the order book, if possible, will show which is the true explanation. From the information given by the Trading Accounts no valid inferences can be drawn, either as to the prices paid or realized or to the quantity of goods sold. We have, in fact, the mathematician's despair, one equation with two unknowns. Supposing we could ascertain the number of articles bought, sold and left on hand, we could then easily calculate the prices.

We might find this for Year II:

or this:

	A			B		
	No. of Items	@	£	No. of Items	@	£
Opening Stock . . .	168	£4	672	168	£4	672
Purchases . . .	1,334	£5	6,670	1,113	£6	6,670
	1,502		7,342	1,281		7,342
Less Closing Stock . . .	504	£3/10/0	1,764	252	£7	1,764
Cost of Sales . . .	998	£5/11/9	5,578	1,029	£5/8/5	5,578
Gross Profit . . .		(30%)	2,392		(30%)	2,392
Total Sales . . .	998	£7/19/9	7,970	1,029	£7/14/11	7,970

The selling price in *B* is 4s. 10d. lower than in *A*, and the cost of sales per article is also lower, 3s. 4d., and there are trifling differences in the numbers of articles sold, but it should be noted that the purchase and selling prices are *average* prices only. It may be that in fact not one single article was bought or sold at those prices.

The startling and significant thing, however, is the figures for closing stock. *A* shows a large quantity of stock (three times the opening stock), but valued at a price 30% below the

average purchase price. As stock is valued at cost or market selling price, whichever is the lower, it indicates that in the last few months of the year cost prices have fallen markedly; or that there has been a break in the selling price to less than half the average for the year; or else that there has been a substantial and perhaps deliberate undervaluation of stock. *B*, on the other hand, shows that stock has been valued at a figure in excess of average cost, and as no one is likely to over-value closing stock (which would inflate his profit), this can only mean that in the closing part of the year the cost of the articles has risen steeply.

All these extremely diverse business experiences are equally consistent with the same trading account figures. And even with the added information as to quantities which, in practice, could never be made available in a business of any complexity, the banker still could not learn from the accounts which of the possible reasons already given for the increased number of articles unsold at the end of the year (200% increase in *A* and 50% in *B*) is the true one.

It may be rewarding to go one step further with this simple Trading Account and to see how Account *A* might have actually moved quarter by quarter.

Here then we have a position perfectly consistent with the Trading Account *A*, but which could not possibly have been inferred from it. All or any of the following explanations may apply:

- (1) A sudden change from scarcity conditions to plenty:
i.e. a natural break in wholesale prices;
- or (2) The introduction of controlled wholesale prices;
- or (3) The introduction into the market of cheap competitive lines;
- or (4) The imposition of a heavy purchase tax, increasing prices to the consumer and creating or strengthening strong consumer resistance.¹ (Purchase Tax might well be excluded from the Trading Account altogether.)

¹ This actually occurred in connection with the radio trade in 1948 and completely dislocated the markets.

YEAR II				ACCOUNT A		
				Articles	@£	£
Opening Stock				168	.	672
Purchases:						
1st Qr.	400	@	£4/10/0			1,800
2nd Qr.	200	@	£6			1,200
3rd Qr.	434	@	£6/1/0			2,620
4th Qr.	300	@	£3/10/0			1,050
						<u>£6,670</u>
				1,334	5	6,670
Less Closing Stock				1,502		7,342
				504	£3/10/0	<u>1,764</u>
Articles Sold and Cost of Sales.				998	£5/11/9	5,578
Gross Profit (30%)						<u>2,392</u>
Sales:						
1st Qr.	300	@	£7			2,100
2nd Qr.	350	@	£9			3,150
3rd Qr.	250	@	£8/10/7			2,132
4th Qr.	98	@	£6			588
Sales 988				998	£7/19/9	<u>£7,970</u>

The sole clue to the significant recession in sales during the last quarter might be a marked falling off in Debtors in the balance sheet: and if there were such a business – dealing in one article only – the branch manager might well be aware of the change in the market. In a more complex business, however, it would be well-nigh impossible to read the Trading Account aright: especially as the debtor figure in the balance sheet might be affected by heavier credit and lighter cash sales, as consumer resistance made itself felt, or by quicker or slower collections.

It can now be asserted that any valid comparison between related figures in revenue accounts and balance sheet is only possible on the assumptions that:

(1) The trading proceeded evenly throughout the year.

(2) The balance sheet – struck at the end of the year – gives a fair picture of the position which, subject to accruing profits, has obtained throughout the year. The validity of the various financial ratios, and of inferences drawn from changes therein year by year, will have to be considered in the light of these two propositions.

The quarterly percentages for the value of purchases and sales are a sufficient commentary on the first assumption.

YEAR II				ACCOUNT A	
				Purchases	Sales
				%	%
1st	Qr.	.	.	27	26
2nd	Qr.	.	.	18	40
3rd	Qr.	.	.	39	27
4th	Qr.	.	.	16	7
				<hr/>	<hr/>
Total Purchases				100	Total Sales 100
				<hr/>	<hr/>

THE INTERRELATION BETWEEN BALANCE SHEET AND REVENUE ACCOUNT

This survey of revenue accounts and some of their inadequacies as indicators of the course of the business during the year makes it possible to consider now the real nature of the relationship between the revenue accounts on the one hand and the balance sheet on the other. The first shows *the way* in which the main changes in the undertaking's position – those brought about by its normal trading operations – have come about during the year. The second shows the end-year position and, by comparison with the previous year's balance sheet, just what the results of those changes have been. If just weight is to be given to the correlation of revenue with balance sheet items which are expressed in so many of the accepted accounting ratios, it is important to realize that in many instances we are comparing things which are not really parate.

'In all attempts at comparison it is axiomatic that like must be compared with like, whether the comparison be between the figures of two or more accounting periods or between the figures of similar concerns, or again between interrelated items in the balance sheet or revenue account. To contrast figures or groups of figures that are not properly comparable is not only of little use, but is apt to prove peculiarly misleading and to that extent a source of danger.'¹

How far, then, can figures in a balance sheet be said to be 'properly comparable' with related figures in the revenue accounts?

¹ *Design of Accounts*, Bray and Sheasby.

The answer depends on a true understanding of what a balance sheet really signifies. It has been likened to a snapshot taken of something in motion. There can be few readers who have not at some time looked over the snapshot album of a friend who explains, 'That's my father.' Then noticing the observer's silence and his quickly suppressed smile adds, 'But he is not really a bit like that.' How true that may often be for two quite opposite reasons. A single snapshot taken of an entirely unconscious subject may libellously show him to be cross-eyed, hunch-backed or otherwise grotesque; though if a series of pictures discloses the same peculiarity one's belief in the disclaimer falls as one's admiration for filial loyalty grows. On the other hand, every snapshot album will contain portraits which are stiff, self-conscious and posed. There is always a definite danger that in exceptional cases, balance sheets will fall in the 'posed' category, with the subject all dressed up and – as Macaulay scathingly wrote of Robert Montgomery – 'doing his very best to look like a man of sensibility and genius, though with less success than his strenuous efforts deserve'. The directors always know when the balance sheet is going to be taken, and happy the banker who can recognize window-dressing when he meets it.

It may be added that he gets most benefit from the snapshot album who knows the subjects well and has a clear idea what they are really like: and can accept, with such mental reservations as may be necessary, the explanation 'He is not really like that'.

Like all analogies, however, the snapshot idea must not be pressed too far. The camera cannot lie, we are told, and a properly focused instrument will show with clear definition exactly what is seen by the eye of the camera. There can, however, be no such sharpness all over the picture presented by a balance sheet. It is dangerous to approach accounts in the belief 'that it is possible to achieve something approaching photographic accuracy in a balance sheet, when in fact it is necessarily the reflection of opinions subject to a (possibly wide) margin of error'.¹

A much better analogy is that of a 'still' produced when the action of a film running through a lecture room projector is

¹ *Financial Accounting*, G. O. May.

stopped for a moment to enable a particular position to be closely examined. It is then viewed instinctively as a matter of suspended motion in connection both with the movements which led up to that position and those into which it merges when the projector is started up again. Moreover, the 'still' only has significance in relation to the movements *immediately* before and after the position studied. This consideration must be kept in mind when the true interrelation between balance sheets and revenue accounts is discussed in Chapter IX.

CHAPTER VII

INSOLVENCY – THE BANKER’S SPECIAL APPROACH – THE THEORY OF CASH CIRCULATION

WHEN, as lending bankers, we examine accounts, what are we really looking for?

Two main issues stand out – insolvency and the nature of cash circulation: the two are closely inter-locked.

INSOLVENCY

When lending, the banker is vitally concerned with the safety of his advance and must assure himself that there is reasonable prospect of reductions and repayment if things go according to expectations: and that if the unforeseen should happen and his customer should fail his assets will realize enough, in conjunction with any third-party security, to prevent loss to the bank. In other words, he looks at his borrower’s accounts to satisfy himself that the customer is solvent.

There are two kinds of insolvency:

- (1) ‘Going-concern’ insolvency arises when the customer is unable to pay his debts as they become due.
- (2) ‘Gone-concern’ (or commercial) insolvency arises when, on winding up and after realization of all his assets, the customer is unable to pay 20/- in the £, i.e. when total liabilities exceed total realized assets.

The first arises, and indeed can only arise, while the business continues. Its essence is a shortage of *cash* of the right amount and at the time required and inability to raise cash by borrowing or otherwise: in other words an unliquid position. And the word ‘liquidation’ is aptly used to describe the winding up of a company, for that is exactly what happens. All the assets are turned into cash. Clearly it is possible for an individual to be unable to pay his debts as

they become due and still be able to pay 20/- in the £ when his assets, including the fixed assets, are sold up. Equally it is possible for him to have ample liquid resources to meet current liabilities and yet, on winding up, to have insufficient to discharge his liabilities, including his long term debts.

This is not the place to discuss bankruptcy law in great detail, but it is certain that, in practice, the majority of failures are precipitated by 'going-concern' insolvency, which is normally the immediate cause of the most usual acts of bankruptcy, e.g.:

- (i) Debtor filing a declaration that he is unable to pay his debts;
- (ii) Debtor filing his own petition;
- (iii) Giving notice that he has suspended payment;
- (iv) Failure to satisfy a bankruptcy notice within seven days;

and the probable cause of most of the others, e.g.:

- (a) Assignment of debtor's property for the benefit of his creditors;
- (b) Fraudulent conveyance or preference;
- (c) Avoiding creditors with the intent to delay or defeat them;
- (d) Execution levied against debtor's goods.

Similarly, by far the most usual cause for the winding up of a company by the Court is that the company is unable to pay its debts¹, the tests of which are:²

- (a) Failure to pay or satisfy, within three weeks of service of demand, a creditor for over £50;
- (b) An unsatisfied execution issued by a judgement creditor;
- (c) Proof to the satisfaction of the court that the company is unable to pay its debts (contingent and prospective liabilities of the company being taken into account).

¹ Companies Act, 1948. Sec. 222 (c).

² *ibid.* Sec. 223.

It will be seen that none of the causes detailed above refers either in bankruptcy or company liquidation to inability *ultimately* to pay 20/- in the £.

In considering a bankrupt's application for discharge, the Court may have regard to both kinds of insolvency and refuse or suspend discharge if the bankrupt has:

- (a) Continued to trade after knowing himself to be insolvent:¹ which means here inability to pay 20/- in the £;²
- (b) When unable to pay his debts as they become due has, within three months of the receiving order, given undue preference to any of his creditors.³

Both kinds of insolvency are material to the validity of a floating charge under Section 322 of the Companies Act, 1948, which provides that a floating charge created within twelve months of the commencement of the winding up shall be invalid (except as to the amount of cash paid to the company at the time of creation or subsequently) unless it is proved that immediately after the creation of the charge the company was solvent. The burden of proving that the company was solvent lies on the holder of the floating charge.

'The company may be insolvent in either of two ways:

- (1) If the property "left" is not enough to pay its debts (re *Stainton*, 19 Q.B.D. 182, etc.). For this purpose all the assets and all the liabilities must be considered.
- (2) If the company is unable to pay its debts as they fall due (*London Counties Assets Co. v. Brighton Grand Concert Hall* (1915) 2 K.B. at p. 496). For this purpose it is immaterial that the assets exceed the liabilities. (*Hodson v. Blanchards (London), Ltd.* 131 L. T. News. 9.)⁴

If a banker, relying on a floating charge, is unable to prove solvency by *both* tests, it is little consolation that the debt

¹ Bankruptcy Act, 1914. Sec. 26 (3) (e).

² *ibid.*, Sec. 26 (3) (h).

³ Re *Freeman*, Ex Parte *Freeman* (1890).

⁴ *Palmer's Company Precedents*, 14th Edition, Part III at p. 77.

remains¹ even if the floating charge is invalid; for his only remaining right of proof as an unsecured creditor may involve heavy loss.

THE BANKER'S SPECIAL APPROACH

It has already been stated that no prudent banker would become involved in an advance to a company if his only assurance of ultimate repayment were winding up and liquidation. He dare not do so in reliance on a newly taken floating charge as security for an already existing debt unless he is equally satisfied that on the current position the company can meet its debts as they become due. It is here urged that 'going-concern' solvency, and with an ample margin, should be the banker's paramount consideration. If there is a cushion of fixed assets in case of trouble, that is all to the good: alone, it is not enough.

How then, can the banker find the necessary assurance in the accounts of his customer? It has been said that if 'liquid assets and book debts together exceed the trade creditors and loans, then it is safe to assume clear solvency, and the degree thereof is determined by the amount of the excess.'² That is an over-simplification, although on a 'gone-concern' basis the statement may have some justification. But, on the 'going-concern' basis, the aggregate of creditors and loans is not the sole measure of cash requirements. Weekly wages may involve weekly requirements for cash which liquid assets and the inflow of collections cannot supply. It is notorious that when a business gets into serious difficulty it is often the inability to find wages which finally brings it to a stand-still and changes its status from that of a 'going-concern' to that of a 'gone-concern', and the ability of debtors to provide ready cash is often misunderstood. Says the same writer:

'Sometimes a percentage of the book debts is taken as representing ready money. This is normally quite justified, especially where a large trade credit is indulged in. Thus, suppose the book debts total £60,000, then undoubtedly a considerable proportion of this amount outstanding will be paid at a fairly even rate throughout the year *in addition to current pay-*

¹ Re *Parkes Garage (Swadlincote) Ltd.* (1929), 1 Ch. 139.

² *Balance Sheets, Explained, Analysed and Classified*, H. Kaner.

ments. It can, therefore, be presumed that during any particular month a sum of at least £5,000 may be counted on to be received in respect of payments of debtors. It will be appreciated that this influx of money is quite as fluid as other forms of liquid assets. . . .¹

The view expressed, namely that the amount of debtors at the beginning of the year will be entirely collected by the end of the year, *in addition to current payments*, will probably be met with surprised incredulity. The fact is, of course, that the amount received in any one month will normally be determined mainly by the amounts invoiced one, two or three months earlier (according to the length of credit customary in the trade) and has no relation at all to the total amount of Debtors outstanding at any one time. Collections will tend to vary with credit sales, but with a time lag. Similar considerations apply to purchases and the payments which have to be made from time to time to trade creditors.

‘The real question which presents itself when a current position is being examined, and which requires a good deal of penetration for its solution, is how fast will liquid resources be available to meet current liabilities, i.e., is the normal inflow and outflow of operational liquid resources in equilibrium at all points in the accounting period? This question is correlated to others which pertain to working capital, e.g., (1) are the current assets becoming liquid fast enough to meet the cost of materials, wages, and expenses entering into production? . . . (2) finance new developments, or . . . (3) take advantage of special opportunities?’²

The ebb and flow of cash is clearly the ultimate consideration. Its movements are illustrated graphically on the next page.

It is quite clear that the life blood of this system is cash, which carries vitality into every stage of production up to finished stock. If there is any monetary anaemia the vitality of the whole organism quickly suffers.

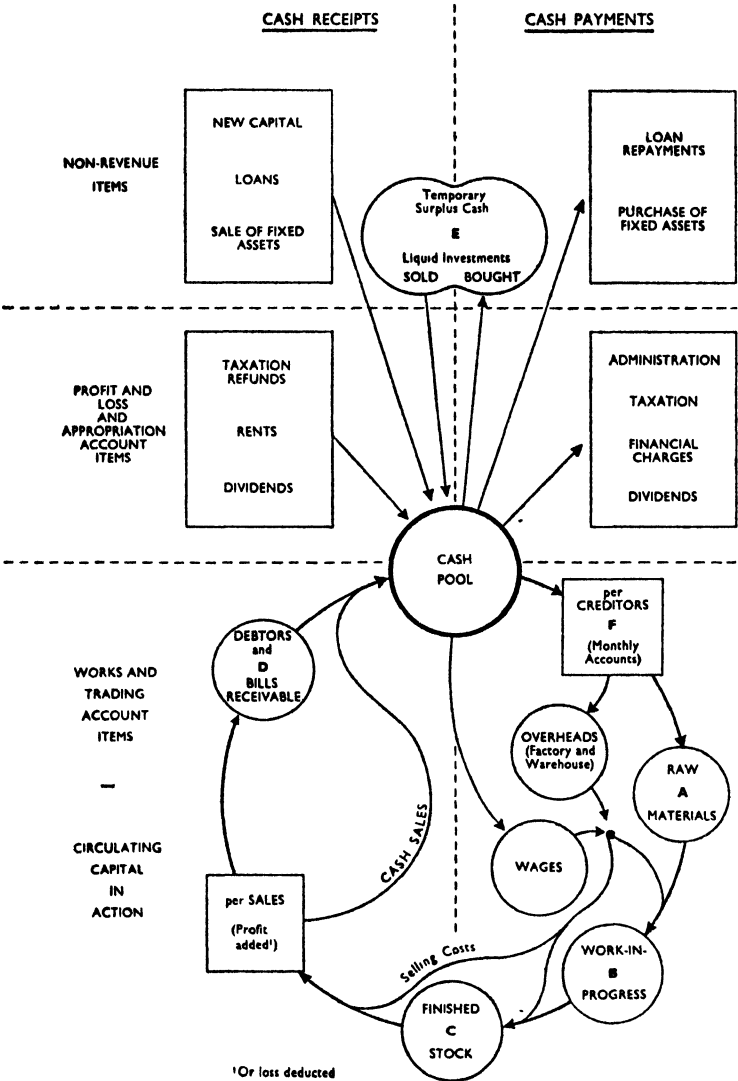
It is also important to note that if raw materials, work-in-progress and stock are valued at *prime cost* all changes in the

¹ *Balance Sheets, Explained, Analysed and Classified*, H. Kaner. The italics are the present writer’s.

² *Design of Accounts*, Bray and Sheasby.

Example XIV

THE PLACE OF CASH IN A WORKING BUSINESS



asset make-up from cash to stock will merely be a change in kind and not in value. It will be simply a case of asset for asset.

The next operation, the sale of stock, introduces an entirely new element. An asset, stock, valued at cost $\pounds C$ is exchanged for another asset, whether cash, debtor or bill receivable valued at $\pounds C + P$, where P is the profit (or $\pounds C - L$, where L is the loss). When profit is made and *realized*, cash will steadily increase as it circulates to the extent of profits made. But this is not a closed circulatory system and there will be inevitable withdrawals as shown in the diagram. If the position becomes too full-blooded, excess cash may be drawn off within the system and invested (E : liquid investments).

If the withdrawals, which include payments of bank charges and loan repayments, exceed the normal cash increment from profits or special receipts, the strength of the organism will diminish. If such a condition is protracted the position may become so critical that only a liberal transfusion of fresh cash will restore normal health. It will be equally disastrous if the channels of circulation are clogged. Actual shortage of raw materials will stop production at its source; physical bottle-necks may retard work-in-progress, and the process may lag before finished stock emerges. Even when ample supplies of finished stock are coming forward, diminished sales and slower debtor collections may slow down the return of cash and create a position where the natural increase is insufficient to cover the withdrawals. This, in turn, brings about a fall in cash pressure at all the points where it normally boosts production and the whole cycle of circulation becomes sluggish.

Let us revert to our illustration of the stopped cinematograph film and look at the diagram as a 'still'. The circulation of the current assets which may, at the balance sheet date, be either vigorous or sluggish, is notionally suspended. It will be clear that the values appearing at A, B, C, D, E and F in the balance sheet can tell us nothing regarding the *rate of flow* at the balance sheet date, nor indicate whether the return of cash to the pool (normally the bank) provides an adequate margin over cash disbursements. The actual cash at bank and in hand, and of other liquid resources (E),

will, of course, be known, but at points A – D inclusive the balance sheet figures represent only potential cash.

The analogy of an electrical circuit is very suggestive. Potential or voltage will do no work and yield no power unless there is an adequate amperage or rate of flow. Voltage multiplied by amperage = wattage or effective power; and just as a power of 1,000 watts will be given equally by 20 volts at 50 amps. or 250 volts at 4 amps., so in a business small circulating assets with a quick cash conversion rate will produce as much cash power as large circulating assets with a slow cash conversion rate. This perhaps throws some light on the old and eminently sound business adage, 'small profits and quick returns'.

If a banker looks at a balance sheet to ascertain whether on winding up his customer can pay 20/- in the £, he will look in vain.¹ And if the balance sheet is only a month old the current position will probably have altered materially. As far as the fixed assets are concerned, any relation between the book figures and realizable value is purely accidental, since normally the figures are based on historical cost, possibly written down to an estimate of value to the business as a going concern: their value as the empty shell of a defunct business is a matter of a fresh and direct appraisal.

The chief thing a lending banker wants to learn from his study of the accounts is whether the cash flow will be adequate to keep points A, B, C and F properly supplied and to meet at least the demands of the overheads, including bank charges; and loan repayments: in short, to keep the business healthy and alive: and, if not, whether outside resources in the shape of available additional capital, further borrowing on the security of unencumbered assets, or the further sums he will himself be prepared to advance in case of need, will suffice to redress the position.

It is in the light of this overriding consideration as well as of the other matters previously discussed that the validity of the various financial ratios can now be examined.

¹ The question of breaking up a balance sheet is discussed more fully in Chapter XI¹

CHAPTER VIII

ACCOUNTING RATIOS

Summary of Ratios – The Balance Sheet Ratios – Drs./Crs. Ratio – Current Ratio – Liquid Ratio – Revenue Account Ratios – Gross Profit Ratio – Net Profit Ratio – Sales/Purchases Ratio.

THE accounting or financial ratios which are available as tools to all who have to analyse accounts and appraise the realities which lie behind them, require detailed examination in order to determine their validity and their value to the lending banker. He will want to know:

- (1) To what extent they are theoretically sound;
- (2) Whether they are an essential part of his equipment or just academic frills of no use to the practical man.

The generally recognized ratios fall into four groups. They are:

(1) BALANCE SHEET RATIOS

- (a) Liability Ratio;
- (b) Asset Ratio;
- (c) The Debtors/Creditors Ratio;
- (d) The Current Ratio;
- (e) The Liquid Ratio.

(2) REVENUE ACCOUNT RATIOS

- (a) Rate of Gross Profit;
- (b) Rate of Net Profit;
- (c) Sales/Purchases Ratio.

(3) BALANCE SHEET/REVENUE RATIOS

- (a) Rate of Turnover (or Stock/Cost of Sales Ratio);
- (b) Creditors/Purchases Ratio;
- (c) Debtors/Sales;
- (d) Stock/Sales;
- (e) Working Capital/Sales;
- (f) Net Return Ratio.

(4) LENDING RATIOS

BALANCE SHEET RATIOS

(a) THE LIABILITY RATIO and (b) the ASSET RATIO have been considered in Chapter II. It has already been pointed out that, generally speaking, the liability figures are records of actual historic fact in that the total fund of assets was actually provided in the stated proportions by the proprietor, the loan and current creditors and the bank. The liability ratio is therefore wholly valid subject only to the proviso that the profits ingredient in the net worth figure is not entirely free from the 'opinion' element.

(b) The ASSET RATIO on the other hand suffers from the fact that so many of the figures involve a high degree of estimation. Moreover, while the current assets will be evaluated mainly on the basis of recent prices, many of the fixed assets may stand in the books at cost many years ago, which may have no relation to current values. Any comparison between fixed and current assets totals may therefore be distorted.

(c) THE DEBTORS/CREDITORS RATIO

Since selling and buying are closely associated features of day to day business, debtors and creditors logically based on and arising out of these operations have a definite and special association, crystallized in the suggestive Debtors/Creditors ratio. It is computed by dividing debtors and bills receivable by the figure for trade creditors plus trade bills payable.

From *Example X* (at page 69 *ante*)

'MANUFACTURERS LIMITED'				
DEBTORS/CREDITORS RATIO				
31st March				
1946	$\frac{\text{Drs. \& Bills}}{\text{Creditors}}$	=	$\frac{27,000}{5,000}$	= Ratio 5.4
1947			$\frac{22,000}{17,000}$	= Ratio 1.3
1948			$\frac{17,000}{43,000}$	= Ratio 0.4

It is clear that if a merchanting business sells only on credit and receives the same length of credit (14 days,

1 month, or as the case may be) and a selling profit is being made, the Debtors/Creditors ratio should normally be greater than unity, except perhaps seasonally, when stocks are being built up. This is because the creditor figure is based on the value of goods at cost, while the debtor figure is based on such cost, *plus profit*. In a manufacturing business the ratio should be much higher, since the creditor figure will be represented mainly by the cost of materials, but the debtor figure will be based on cost of materials, the cost of processing (wages and works on-cost) and profits. On the other hand it may often be possible for the manufacturer to obtain longer credit than he allows, when the ratio will be modified accordingly.

The three-year Debtors/Creditors ratios shown above reveal a marked and, indeed, serious trend, and unless the fall can be off-set by a large increase in liquid resources, e.g., from cash sales or fresh capital, it is almost certain that disaster is not far off.

The foregoing is only the statement of a broad principle which, in the infinite variety of business, may be modified to almost any extent. For example, a retailer may buy on credit and sell mainly for cash. In such cases creditors may quite properly exceed debtors, and the ratio will be a small fraction only. The main point is to establish a ratio for a given business and note carefully the changes from year to year. The significance of such changes is classified in the following table:

INTERPRETATION OF VARIATIONS IN DR./CR. RATIO

Favourable sign when due to:

Unfavourable sign when due to:

RISE

- (1) Prompter payment of creditors and/or
- (2) Increased debtors following increased sales.

Increased debtors, owing to slower collection.

FALL

Reduction in debtors due to more efficient collection or increased proportion of cash sales.

- (1) Making creditors wait for their money and/or
- (2) Increasing creditors and abnormal increase in stock without increasing debtors and/or
- (3) Decreasing debtors by reason of (a) falling sales
(b) pressing debtors with damage to goodwill.
- (4) Discounting bills receivable.

All or any of these factors may act together and indeed may cancel each other out. In bad times a trader might both take and have to allow longer credit without the ratio being affected at all. Like most ratios therefore the Debtors/Creditors ratio is suggestive rather than positive in the information it gives. But its value in assessing trends is greatly increased when it is considered in conjunction with other ratios.

In working out the Debtors/Creditors ratio the purpose of the comparison and the foregoing comments should be borne in mind, and only the correct items should be taken from the balance sheet. Broadly speaking the debtor figure should include only those items – trade debtors and bills receivable – directly associated with sales; and the creditors figure only those trade creditors directly associated with purchases. Expense creditors, bank overdrafts and taxation liabilities should be disregarded, as their inclusion will introduce arbitrary variations. These items will play their full part in connection with the current asset and current liabilities ratio, which will be considered later.

But even when accurately worked out, the reliability of this ratio must be suspect. If the business had been wound up at the balance sheet date, it would have been a fair indication of ability to meet trading liabilities. But it must be remembered that as soon as active trading ceases the natural relationship between debtors, as a main source of cash, and creditors, as one of the main calls for cash, ceases: and current liabilities rank *pari passu* with long-term liabilities as claimants against the assets as a whole. On a 'going-concern' basis its validity may be affected by the following considerations:

- (1) (a) The rate of debtor collections is not determined by the Debtor figure in the balance sheet but by the amounts due month by month as determined by sales for the months immediately preceding the balance sheet date;
- (b) Similarly, the amounts payable to creditors month by month vary in step with recent purchases;

(c) There is thus no logical connection between the two figures unless there is – adventitiously – a close balance between purchases and sales in the relevant periods.

(2) The ratio may be considerably affected by the extent to which purchases and sales are made for cash: and this will not be ascertainable from the accounts supplied.

Nevertheless, any marked fall in the Debtors/Creditors ratio should prompt enquiry. The answers may provide a satisfactory explanation: indicate a state of stringency in which debtors are being pressed and some creditors left unpaid: or, indeed, that for window-dressing purposes debtors have been ‘whipped up’ to improve the cash showing in the balance sheet.

(d) THE CURRENT RATIO

Most writers on balance sheet interpretation emphasize that the ratio $\frac{\text{Current Assets}}{\text{Current Liabilities}}$ (generally known as the current ratio) is an important one, because current liabilities can only be discharged out of current assets: no business could continue on the basis of selling fixed assets for the purpose.

‘Let us suppose that a borrower presents a statement showing:

	£		£
Current Liabilities	50	Current Assets	200
Long-term Liabilities	350	Fixed Assets	200

The borrower would have, according to this statement, a ratio of quick assets to current liabilities equal to 4 : 1. If a bank loaned the maker of the statement £50 the ratio of quick assets to current liabilities would be $2\frac{1}{2}$: 1, a ratio that is regarded as safe.¹ This ratio is based on the following reconstructed statement:

¹ *Bank Credit*, C. A. Phillips.

Bank Loan	£ 50	Current Assets	£ 200
Other Current Liabilities	50	Addition	50
	<hr/>		<hr/>
Total Current Liabilities	100	Total Current Assets	250
Long-term Liabilities	350	Fixed Assets	200

It will be noted that the current ratio of $2\frac{1}{2}$ deduced by Phillips is based on two assumptions:

- (1) that the bank loan is a current liability;
and (2) that it is utilized solely to acquire additional *current* assets.

Phillips is discussing unsecured and probably temporary borrowing on a note, in the way customary in the United States, and the first assumption is therefore reasonable in this case. In this country the treatment of bank overdrafts in computing the current ratio is not entirely free from difficulty however, especially in view of the fact that at the date of the balance sheet or other statement under review, the agreed limit of overdraft may not be fully used.

Taggart suggests that 'bank overdrafts are (i) current liabilities if casually occurring, (ii) fixed liabilities if a regular feature of business finance'.¹ Certainly it would be unrealistic when considering accounts to insist rigidly on the strict legal position that, in the absence of agreement to the contrary, all bank loans are repayable on demand, when it is quite clear on the facts that there is a very real element of lock-up. If for instance there is an agreement for a loan of £10,000 to be repaid at not less than £1,000 per annum, for the purpose of the current ratio it would be reasonable to regard any reductions due to be made within twelve months of the balance sheet date, including arrears (if any), as a current liability; and to treat the balance of the loan as a fixed liability. After all, the purpose of the ratio is to compare short-term receivables with short-term payables. But in the absence of any such arrangement, the investigator must use his common sense, in the light of all the facts. For instance, where a banker holds a debenture giving a fixed charge over a factory and a floating charge over the rest of the assets, and his lending basis is, say, £20,000 against the property,

¹ *Profits and Balance Sheet Adjustments*, P. Taggart.

any excess up to a total borrowing of £40,000 to be covered by twice the amount of the current assets (certified monthly), it might be reasonable to treat the first £20,000 as a fixed liability, and the balance as a current liability, if the amount in excess of £20,000 is only taken occasionally for seasonal purposes. Each case must be considered on its merits.

Where at a given date the sanctioned limit is not being fully used Taggart – the only writer who seems to have dealt with the point – says, ‘Preferably the permit limit should be entered as a capital liability and the unborrowed part as a circulating resource, described as a “bank balance available”.’¹ Consider the following position.

	£		£
Net worth and fixed liabilities	40,000	Fixed Assets	46,500
Bank Overdraft	17,000	Stock	10,000
Current Liabilities	16,000	Debtors	16,000
		Cash	500
	<u>£73,000</u>		<u>£73,000</u>

Assuming the bank debt to be a ‘regular feature’ and therefore to be regarded as a fixed liability, the current ratio would be 1.66. If there is an overdraft limit of £40,000, Taggart’s adjustment would be:

	£		£	£
Net worth, etc. . . .	40,000	Fixed assets		46,500
Bank Overdraft		Stock and		
(Fixed Liability)	40,000	Debtors		26,000
Current Liabilities	16,000	Cash	500	
		Bank Borrowing available	23,000	
			<u>23,000</u>	<u>23,500</u>
	<u>96,000</u>			<u>96,000</u>

The current ratio would then be 3.1.

The difference between the two current ratios would therefore be substantial. The purpose of the ratio being to compare current resources with liabilities which have to be met, the figure of 3.1 is correct. But the adjustment is only valid on

¹ *Profits and Balance Sheet Adjustments*, P. Taggart.

the assumption that the undrawn £23,000 is available *whatever the purpose for which it is taken*. On a lending basis of £20,000 against the fixed assets, plus 50% of the current assets, the bank borrowing could only be increased to £33,250 except in so far as the money is utilized to augment current assets. That is to say that if cheques were drawn to pay off the creditors, to repay long-term liabilities or to purchase fixed assets, the available limit would be £33,250 only, not £40,000. The application of the suggested adjustment is therefore beset with difficulties and incapable of employment in practice, however correct in theory. In any case when the banker is considering an initial proposal for an advance, the difficulty does not arise. Thereafter when he has committed himself to a limit, the current ratio is of reduced importance, and can still be used, without Taggart's suggested adjustment, to watch significant changes in the current position.

As a matter of fact the problem is not new: it has frequently been discussed in relation to the balance sheets of the banks themselves. Banks set themselves a definite proportion of cash to be held in relation to probable demands as measured by the balances on current and deposit accounts, etc. It might be argued that entries should appear in a bank's balance sheet to record facilities sanctioned, but undrawn, thus:

Undrawn amounts available to custo- mers under faci- ties sanctioned	£5,800,000	Future liability of customers on loans & advances approved but un- drawn, per contra	£5,800,000
-------------------------------------------------------------------------------	------------	--------------------------------------------------------------------------------------------------	------------

The clerical work involved and the difficulties to be surmounted in giving effect to this conception would be enormous. Furthermore, there are plenty of sanctioned limits kept available in case of need which are lightly used, or often never used at all. Where the banks and their auditors have decided to leave well alone, the bank credit man can safely adopt the same approach. For practical purposes when assessing a balance sheet and the current ratio, undrawn bank facilities should be kept well in mind where they are a material factor, but any consequential adjustment of the figures can be

dispensed with and, on balance, is not to be recommended.

Phillips was a pioneer in popularizing the current ratio as one of the most useful of banker's tests, though in his day it was applied mainly to simple, up-to-date statements of affairs drawn up for the banker by the customer, rather than to the formal and often stale audited accounts which are now customary. Let him speak for himself: 'Credit men are even more concerned about the ratio of current¹ assets to current liabilities than they are about the net worth . . . of the applicant for a loan. Net worth may be very great but in the form of fixed¹ assets. The banker fails to safeguard the interests of his depositors and shareholders unless he uniformly insists on a safe ratio of current¹ assets to current liabilities. What constitutes a safe ratio varies from case to case, but hovers round 2 to 1, *after the desired loan has been included*. Allowance for shrinkage of 50% is generally regarded as sufficient and when the moral risk is exceptionally good, earnings highly satisfactory or fixed assets exceptionally large, a ratio of appreciably less than 2 to 1 may be acceptable. Departure from the 2 to 1 rule is very common.'²

'As always with indices, there is a danger of treating this ratio too rigidly, but where a business has reached a normal state of progress, it is a ratio which should only move within settled limits over an accounting period. Any movement outside these limits should be closely investigated . . . The significance of the current ratio lies in the fact that it may be regarded both as an index of solvency and as an index of strength of working capital. . . . Moreover the calculation of this ratio on the basis of total current assets may unwittingly lead to unwarrantable inferences where heavy inventories (that is, stock and work-in-progress) are being carried.'³

It may be helpful to extract the current ratios from the nine weekly balance sheets in Example VI set out in Chapter V, and to test them against the foregoing principle that the ratio should move within settled limits over an accounting period.

¹ Phillips actually employs the terms 'quick' and 'slow', where throughout this book the writer has used 'current' and 'fixed': to avoid confusion the liberty has been taken of substituting the latter terms for the former in this passage.

² *Bank Credit*, C. A. Phillips.

³ *Design of Accounts*, Bray and Sheasby.

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CURRENT RATIOS

WEEK	FRACTION	RATIO	
1	$\frac{1,280}{400}$	= 3.2	
2	$\frac{1,350}{550}$	= 2.45	
3	$\frac{1,670}{720}$	= 2.3	(Profits start)
4	$\frac{2,020}{890}$	= 2.27	
5	$\frac{2,550}{710}$	= 3.6	
6	$\frac{2,770}{680}$	= 4.07	} Normal working
7	$\frac{2,970}{680}$	= 4.37	
8	$\frac{2,820}{790}$	= 3.57	
9	$\frac{2,940}{680}$	= 4.32	

Weeks 1 to 5 cover the build-up period during which financial movements were by no means normal; the payment of creditors, reducing both current liabilities and current assets, did not commence until the sixth week. Weeks 6 to 9 do, however, represent normal running, and in spite of the substantial profit build-up, the movement of the ratio between 3.57 and 4.37 conforms to the principle reasonably well.

In an established business, changes in this ratio from year to year should be small, and for the purpose of comparison the ratio is of value. A fall may indicate an overbuying of stock on credit, an over-investment in fixed assets, or excessive dividend payments or drawings: and may be caused by a fall in the rate of gross profit or a marked reduction in sales. As a test of *credit* worth, as recommended by Phillips, the current ratio has to meet the following criticisms:

- (1) It is intended to measure the ability of a business to meet its liabilities; but, in fact, it can only do so effectively if the business were wound up at the balance sheet date when, as already pointed out, the

realizable value of the *whole* of the assets must be considered in relation to the *whole* of the liabilities.

- (2) Applied to a 'going-concern' it ignores completely the fact, already stressed, that the balance sheet figures give no indication of the *rate* of cash inflow week by week, nor of the amounts due to creditors week by week, and sheds no light whatever on the regular cash requirements for wages, P.A.Y.E. and purchase tax payments, and cash purchases. Some estimate of wages can, of course, be inferred from the revenue accounts, but it can only be an estimate: the banker is on safer ground here if he watches the actual wages cheques week by week. Moreover, the ratio ignores completely the *make-up* of the current assets and sets against current disbursements and liabilities, which must be met in cash, assets which could be preponderantly unliquid without affecting the numerical ratio.
- (3) It fails, therefore, as a test of 'going-concern' solvency. As a test of 'gone-concern' solvency it has no significance at all, as the special importance of the working capital position has passed.

As an index of the *strength* of working capital the current ratio has a greater claim. In Example V¹ where the effect of successive purchases of stock on credit was examined, it will be remembered that the amount of the working capital remained unchanged throughout at £5,500. The obvious fall in the liquid strength of the working capital would have been clearly brought out by the changes in the current ratio:

			Current Ratio
a	$\frac{10,500}{5,000}$	=	2.1
b	$\frac{15,500}{10,000}$	=	1.6
c	$\frac{20,500}{15,000}$	=	1.4
d	$\frac{25,500}{20,000}$	=	1.3

¹ Chapter IV at page 57, *ante*.

As this particular example suggests, a fall in the current ratio is valuable as one of the key symptoms of overtrading.

The following current ratios extracted from Exchange Telegraph cards picked out at random, suggest that as a rough and ready guide, a 2 to 1 safety line may not be far out, for sound businesses even differing widely in kind.

	Current Ratio
John Barker & Co. Limited . . .	2.36
Bovril Limited . . .	1.78
Bowmaker Limited . . .	1.13
Courtaulds Limited . . .	1.78
Pinchin Johnson Limited . . .	2.70
Richard Thomas & Baldwins Limited . . .	2.1
Tate & Lyle Limited . . .	1.30
Turner & Newall Limited . . .	1.8

(e) THE LIQUID RATIO

Phillips recognizes, too, the importance of the make-up of the current assets from the point of view of liquidity, and displays a nice judgement of the place of cash in the course of day to day business, when he writes, 'Cash on hand and in banks should be large enough properly to balance the statement. The most approved amount varies with the requirements of different lines of business, but in general bankers like to see from 5% to 15% of the current¹ assets in the form of cash.² If cash is very small the concern is in danger of being unable to meet maturing obligations in the event of a falling off in collections. . . . If the cash is disproportionately large the borrower is impairing his ability to meet future obligations by not keeping at work money upon which he may be paying interest.³ The shrewd and far-seeing borrower will reduce the cash in fair weather and increase it in advance of the storm'.⁴ But 'ample liquid assets should be maintained to meet all current liabilities, since in this connection the value of fixed assets may be of little importance'.⁵

¹ See footnote at the foot of page 99.

² i.e. assuming a current ratio of 2, from 10% to 30% of current liabilities.

³ Or which alternatively will be failing to earn interest.

⁴ *Bank Credit*, C. A. Phillips. He is of course writing of banking practice in America, where advances are normally taken on loan account and overdrafts are illegal.

⁵ *Business Balance Sheets*, F. R. Stead.

The ratio of liquid assets to current liabilities is best expressed as a percentage. It will obviously vary markedly between one business and another, and in the same business at different times. 'In general terms it may be said that when a business is prosperous, cash and bank balances will tend to fall,¹ and the greatest need is for more capital.'² As long as a merchant finds it easy to sell goods profitably he will tend to purchase all he can finance either by utilizing cash received, or on credit. 'The converse is also true; for if trade is bad then it is not wise to invest . . . in goods and therefore cash and bank balances tend to increase.'³ Moreover as purchases are curtailed creditors will fall; though some time lag will occur. In the transition from good trading conditions to bad – and vice versa – the liquid ratio may be expected to show considerable fluctuations, sometimes in the course of only a few weeks.

This ratio has a definite meaning at the balance sheet date but again, and for reasons set out in connection with the current ratio, throws no light on the inflow of cash which will be available from day to day to meet day-to-day payments of all kinds. It is one of the drawbacks of normal accounts that they are not drawn up to satisfy the curiosity of the banker and, in consequence, fail to record in any way the proportion of cash to credit sales. With no reliable information in the accounts as to the ebb and flow of cash, the liquid ratio does little more than indicate the sort of safety margin for contingencies which was held *at the balance sheet date*. It will certainly not be possible to determine whether around that date payments had begun to exceed receipts with a consequent diminishing trend in the cash reserve; whether there was a satisfactory equipoise; or whether the trend was for cash to accumulate. Like all other ratios we have considered the liquid ratio has some significance on a 'gone-concern' basis, but must then be related to all the liabilities and not only current liabilities. It is invalid on a 'going-concern' basis and, with a standard impossible to establish, is of little value in either case. If the ratio falls when trade is good it probably

¹ And profits made will be represented largely by increased circulating, as opposed to liquid, assets.

² *The Principles and Interpretation of Accounts*, H. L. Ellis. ³ *ibid.*

means that the business is being expanded by taking every favourable buying opportunity. If it falls in bad times it indicates pressure from creditors and other calls for cash, which have not been wholly offset by efforts to increase collections. At any time an abnormal payment for fixed or current assets, and any loans made or loans repaid, will reduce the liquid ratio. The important thing – and the liquid ratio will not help here – is to see the cash position in true perspective. ‘At all times a shrewd lender does not fail to ascertain whether cash has been rigged through the accumulation of receipts and the postponement of expenditures.’¹

REVENUE ACCOUNT RATIOS

(a) RATE OF GROSS PROFIT

This is the oldest and most widely used financial ratio derived from the trading account, and expresses gross profit as a percentage of sales. In Example XI the gross trading profit is 24% (A) and 29% (B). It is of value for comparison between two similar businesses, or between different accounting periods of the same business. All, or any of the following factors may contribute to a change in the gross profit rate:

(1) Accounting Factors

- (a) Changes in the division of expense items between the trading and profit and loss accounts.
- (b) Alterations in the basis of stock valuation² (including work-in-progress).

(2) Business Factors

- (a) Stock losses due either to mark-downs or to pilferage.
- (b) Changes in buying and selling prices, i.e. in the rate of actual selling profit, and variations in proportions of goods handled on different profit margins.

¹ *Bank Credit*, C. A. Phillips. It is thought that in the passage quoted, ‘expenditures’ means ‘payments’.

² As the closing stock of one year is the opening stock of the next, any such change will affect the rate of gross profit for *two* years.

- (c) Wage rate adjustments.
- (d) Variations in rates of freight and delivery charges.
- (e) Improvements in productive efficiency: or the reverse, e.g. due to fuel cuts, bottle-necks, strikes, machinery breakdowns, and irregularity of supplies.
- (f) Fire or flood damage, in so far as it is not covered by insurance, bringing about direct losses of stock as well as losses from interrupted trade.

It will be clear, therefore, that a variation in the gross profit rate gives very little information by itself. But the explanations which the banker will naturally seek can throw much light on the following questions:

- (1) Are the factors which have produced a fall in the gross profit rate permanent or temporary?
- (2) Must earlier estimates of future prospects be amended?
- (3) Is the business meeting increasing competition?
- (4) Should the banker's estimate of the quality of the management of the business be revised?

The rate of gross profit rests upon a comparison of figures which are logically comparable and, subject to the foregoing comments, is completely valid. It must be remembered, however, that the rate shown is an average for the whole year for all the departments of the business. In the light of the schoolboy analogy in an earlier chapter, the profits being currently earned at the close of the financial year might have been higher or lower than the average for the year and the trend then may have been towards higher or lower rates of gross profit. A rate of 25% gross profit for the whole of 1948 is therefore no warrant for assuming a similar experience in 1949. But the banker's contact with the accounts of businesses of all kinds (naturally much wider at the Head or district office of the bank than at any one branch) and his knowledge of current conditions and trends may enable him to forecast

at least an order of magnitude for profits on a given turnover. If the ratio compares favourably with the norm for the particular type of business year after year, it is *prima facie* evidence of the soundness of the management. In the U.S.A. where industry is not so secretive as in this country and the disclosure of the sales figure is the rule rather than the exception, it is not unusual for individual corporations to supply their trade association with detailed figures. These are collated into a composite account for the whole industry and circulated to all members who are thus provided with an average set of accounts for comparison with their own.

As a steady build-up of net worth over a period is the best index of sound financial policy, so a steady and adequate rate of gross profit is the most reliable evidence of efficient management.

(b) RATE OF NET PROFIT RATIO

This is similar to the Gross Profit Ratio in that it expresses a known net profit as a percentage of known sales. The net profits from Example XI are 26.7% (A) and 10.3% (B). The ratio is unsatisfactory as a basis of comparing results from year to year because net profits are struck by deducting from sales not only those charges which vary directly with sales (purchases, wages, material and factory costs) but also financial, administrative and overhead expenses, which often do not.

(c) SALES/PURCHASES RATIO

As this ratio represents merely another approach to the information given by the rate of turnover and the gross profit rate, it is of little practical value and is noted here merely because other writers have included it in their list of financial ratios. The Sales/Purchases ratios from Example XI are:

$$(A) \quad \frac{212,000}{142,000} = 1.5$$

$$(B) \quad \frac{486,000}{312,000} = 1.5$$

Assuming that all the goods bought were sold, the factor would indicate a rate of selling profit in each case of 50%

$((1.5 - 1) \times 100)$. But this figure can be ascertained more directly and more accurately from the gross profit rate: and the assumption is seldom valid. As soon as the quantity of goods sold exceeds that of goods bought (postulating a fall¹ in stock), or falls short of purchases (involving a rise¹ in stock), the Sales/Purchases ratio becomes meaningless.

¹ The fall and rise in stock here referred to are in quantities: how this is reflected in balance sheet figures will depend on the relative prices used for valuing opening and closing stock.

CHAPTER IX

ACCOUNTING RATIOS (*continued*)

Balance Sheet/Revenue Account Ratios – Rate of Stock Turnover – The Creditor Ratio – The Debtor Ratio – The Stock Ratio – The Working Capital Ratio – The Net Return Ratio – The Validity of the Balance Sheet/Revenue Account Ratios – The Lending Ratios.

BALANCE SHEET/REVENUE ACCOUNT RATIOS

ALL the ratios in this group are based on the comparison of balance sheet figures with related figures in the revenue accounts.

(a) RATE OF TURNOVER

This is computed by evaluating the fraction:

$$\frac{\text{Cost of Sales for the year}}{\text{Average Stock}}$$

$$\text{From Example XI } A \frac{\pounds 161,000}{\pounds 13,500} = 12 \qquad B \frac{\pounds 346,000}{\pounds 22,500} = 15.3$$

That is to say, the amount tied up in stock is turned over on an average (A) 12 times in the year; a very satisfactory rate indeed. For (B) it is 15.3 times. Stated another way, the money invested in stock is tied up on the shelves for

$$(i) (A) \frac{52}{12} = 4.3 \text{ weeks} \qquad (B) \frac{52}{15.3} = 3.4 \text{ weeks}$$

$$\text{or } (ii) \frac{12}{12} = 1 \text{ month}$$

It is important to remember that the rate of turnover is an average figure for the whole stock. Where different lines are carried some will move much faster and some slower than the average. For instance, in a grocery business perishable provisions like butter and eggs must obviously be cleared every week or two if heavy deterioration losses are to be avoided. On the other hand, bottled and tinned goods can safely be

held for much longer periods. Nevertheless, unless there is any marked change in the proportions of stock of different kinds handled in different years, inferences from changes in the rate of turnover from year to year will be of value. Other things being equal, the faster stock is turned over the better, for it is financially unsound to have capital tied up in stock (with consequent loss of return on capital) to a greater extent than necessary.¹ It is even more important, however, to carry an adequate stock, both in quantity and variety, to satisfy all likely needs. The loss of profit on sales, and of goodwill, too, when a customer has to be told 'Sorry, we are out of stock', would quickly exceed the interest burden of the cost of the necessary additional stocks. The amount of stock which has to be carried must, of course, be determined largely by the ease and regularity with which replenishments can be obtained. Apart from supply considerations, a fall in the rate of turnover is a sign of overstocking or falling sales, or both; and an investigation into both purchasing and selling policy is indicated.

(b) THE CREDITOR RATIO

This ratio will be computed as follows:

$$\frac{\text{Trade Creditors}}{\text{Factory Purchases} + \text{Trading Purchases}}$$

From *Examples I and XI*

$$\text{A} \quad \frac{5,000}{10,000 + 43,000} = .094$$

$$\text{B} \quad \frac{5,000}{100,000 + 185,000} = .0017$$

Length of credit taken

(i) A	$365 \times .094 = 34 \text{ days}$	B	$365 \times .0017 = 6 \text{ days}$
(ii)	$52 \times .094 = 5 \text{ weeks}$		$52 \times .0017 = 1 \text{ week}$
(iii)	$12 \times .094 = 1.1 \text{ months}$		

¹ This general principle was very much modified by E.P.T. considerations during the 1939/1945 war when as soon as the standard profit had been earned the trader was faced with the position that the profits on any further sales during the year would all have gone to the Revenue as Excess Profits. Further trading would have involved the depletion of stocks, often difficult or impossible to replace, without any benefit to the company, and to the detriment of future profits.

It will be noted that the only creditor figure used is that directly related to purchases, taxation and dividend liabilities being ignored.

The *B* term of credit taken is exceptionally low and suggests that the company could, with advantage, take longer credit, or in other words increase its liquid or circulating assets at negligible cost. On the other hand, it may indicate substantial purchases for cash on favourable terms which would be sound business.

With regard to trade credit, it must always be remembered that a debtor has no prescriptive right to receive normal trade terms, or indeed any credit at all, and length of trade credit, whether on open account or acceptance, varies considerably. If general conditions deteriorate or a particular business runs into difficulty, a curtailment of credit is not unlikely.¹

When the Creditor ratio is high, showing a term of credit longer than is customary in the trade, it means one of two things: either that the company is so strong that it can dictate its own terms to its suppliers, or that it is short of cash and cannot pay its accounts as they fall due. The latter is by far the more usual; but the former is by no means unknown. All bankers will have met the customer who complains 'I've a lot of money out which, though overdue, is good; but most of the customers concerned are important, and it would not be wise to press.' If high debtors are in fact due to this cause (and not to inability to pay or to the failure of the customer to render his accounts regularly), what can an obliging banker do but let the overdraft go a little higher?

Although the two inferences are completely contradictory, the 'context' will usually show which applies and no difficulty should arise in practice. In interpreting the Creditor ratio, the banker will naturally have regard to the balance sheet date in relation to seasonal purchasing peaks; and also to the effect of exceptionally large purchases just before the balance sheet date. Such exceptional purchases will often explain an abnormally low creditor ratio.

¹ The writer was recently notified in connection with a business suffering from acute shortage of liquid resources, that several creditors had issued writs and fifty more had refused further supplies excepting against cash.

(c) THE DEBTOR RATIO

This ratio brings out the relationship between sales and outstanding amounts to be collected in respect of sales at the balance sheet date. The fraction is:

$$\frac{\text{Debtors and Bills Receivable}}{\text{Sales}}$$

From *Examples I and XI*.

$$(A) \frac{24,500 + 2,500}{212,000} = .127 \qquad (B) \frac{24,500 + 2,500}{486,000} = .055$$

Accordingly, the length of credit allowed is:

$$(A) \begin{array}{l} (i) 52 \times .127 = 6.6 \text{ weeks} \\ (ii) 12 \times .127 = 1.5 \text{ months} \end{array} \qquad (B) 52 \times .055 = 3 \text{ weeks}$$

The *B* term looks short; a considerable proportion of cash sales is one possible explanation.

The length of credit allowed to debtors varies widely from trade to trade, and is usually longer in a retail business than in a manufacturing or wholesale business. But the retailer often has the advantage of cash sales to offset slow collections in connection with credit sales. As the creditor of one business is the debtor of the other, much the same considerations apply to both the Debtor and Creditor ratios. Exceptional sales just before the balance sheet date will abnormally decrease the debtor ratio and correspondingly increase the apparent length of credit allowed.

(d) THE STOCK RATIO

The purpose of the stock ratios appropriate to the various items which make up the stock – raw materials, work-in-progress, stock complete and ready for sale – is to establish the stock tie-up at the balance sheet date in relation to the amount of business done. How can this be measured? Clearly in a purely retail business the size of the business is determined by the sales. But in a manufacturing or contracting business it is measured by the amount of production or work done. Now the value of production, as ascertained from the accounts, is Sales (representing completed work invoiced), whether to outside customers or to own merchandising department, PLUS

increase in work-in-progress (or MINUS decrease), PLUS increase in finished stock (or MINUS decrease). In Example XI the whole of the finished stock has been 'sold' to the retail department and no stocks are retained in the Factory Account, except those of raw materials.

A word of caution is, perhaps, necessary with regard to work-in-progress. In contractors' accounts it is customary to deduct progress payments from work-in-progress *in the balance sheet* and to extend a net figure for work-in-progress not paid for. But for the purpose of the stock ratios and to ascertain the true production figure, the gross work-in-progress figure should be taken, as it appears in the trading account itself.

From Example XI the true production figures are:

- (A) £99,000 + £4,000 increase in Work-in-progress = £103,000
 (B) £127,000 — £5,000 decrease in Work-in-progress = £122,000

RAW MATERIAL RATIO

$$(A) \frac{5,000}{103,000} = .049 \quad (B) \frac{5,000}{122,000} = .041$$

WORK-IN-PROGRESS RATIO

$$(A) \frac{7,500}{103,000} = .073 \quad (B) \frac{7,500}{122,000} = .061$$

	<hr style="width: 100%;"/>	<hr style="width: 100%;"/>
Total Factory Tie-up	.122	.102
	<hr style="width: 100%;"/>	<hr style="width: 100%;"/>

Equivalent to:

- (A).122 × 52 = 6.3 weeks Production (B).102 × 52 = 5.3 weeks Production

The whole of the finished stock being in the merchandising department, the *finished* stock ratio will be based on sales, and the fraction will be:

$$\frac{\text{Closing Stock}}{\text{Sales}}$$

The figures based on Example XI will therefore be:

$$(A) \frac{20,000}{212,000} = .095 \quad (B) \frac{20,000}{486,000} = .041$$

Equivalent to:

$$52 \times .095 = 5 \text{ weeks}$$

$$52 \times .024 = 2 \text{ weeks}$$

With reference to all these stock ratios, it must be emphasized that the purpose is to establish the stock tie-up *at the balance sheet date*. It is for this reason that the final stock figure is employed and not the average stock as in the rate of turnover calculation.

(e) WORKING CAPITAL RATIO

This valuable ratio is designed to determine the amount of working capital required to sustain a given level of sales in a retail business or of production in a manufacturing business. The case of 'Manufacturers Limited', who conduct a hybrid business, partly manufacturing and partly merchanting, is more complicated and has been specially selected to demonstrate how the working capital ratio is extracted for both parts of the business. Only trade and expense creditors are taken into account, but Liquid assets must be reduced by the amount of non-trade creditors; in this case dividend and taxation £17,000.

ANALYSIS OF WORKING CAPITAL

Examples I and X (1946)

<i>Current Assets</i>	<i>Total (oo's omitted)</i>	<i>Attributable to Factory (oo's omitted)</i>	<i>Attributable to Warehouse (oo's omitted)</i>
Raw Materials . . .	50	50	
Work-in-progress . . .	75	75	
Stock of finished goods . . .	200		200
Debtors and Bills . . .	270		270
¹ Liquid Assets . . .	5	2	3
	<hr/> 600	<hr/> 127	<hr/> 473
¹ Less Creditors . . .	50	25	25
	<hr/> 550	<hr/> 102	<hr/> 448
Working Capital . . .	<hr/> <hr/> 550	<hr/> <hr/> 102	<hr/> <hr/> 448

The Factory working capital ratio deduced from Example XI is therefore:

$$\begin{array}{rcl}
 \text{(A)} \quad \frac{\text{Working Capital}}{\text{Production}} & = & \frac{102}{1,030} \\
 & = & .0903 \\
 & \text{or} & 9.03\%
 \end{array}
 \qquad
 \begin{array}{rcl}
 \text{(B)} \quad \frac{102}{1,220} & & \\
 & = & .0836 \\
 & \text{or} & 8.36\%
 \end{array}$$

¹ The apportionments here are arbitrary, but could, in practice, be made accurately.

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That is to say, for every £100 of production at selling price £9/0/7 (or (B) £8/7/2) of working capital is required.

The corresponding warehouse figures are:

$$\begin{array}{rcl}
 \text{(A) } \frac{\text{Working Capital}}{\text{Sales}} & = & \frac{448}{2,120} \\
 & = & .2207 \\
 & \text{or } & 22.1\%
 \end{array}
 \qquad
 \begin{array}{rcl}
 \text{(B) } \frac{448}{4,860} & = & .092 \\
 & \text{or } & 9.2\%
 \end{array}$$

indicating that for every £100 of sales £22/2/0 of working capital ((B) £9/4/0 was employed at the balance sheet date.

The value of these working capital ratios is obvious, for they give an indication of the additional working capital which will be required for a contemplated expansion of business. Experience shows, however, that over and above the figure deduced for a given expansion, an adequate addition should be allowed to cover:

- (1) Extra requirements during the transition period.
Expanded production inevitably involves teething troubles and takes time to fructify.
- (2) The probability that the law of diminishing returns may operate: beyond a certain stage a progressively lower return may be expected for equal additional doses of capital.
- (3) An ample margin for the unexpected: the working capital ratio can only indicate an order of magnitude.

It is the experience of most bankers that while usually business men fully understand and allow for capital requirements for buildings, plant and machinery, they sometimes underestimate or even ignore the essential working capital; and in such cases the business is handicapped from the very start, unless the bank is prepared to come to the rescue.

(f) NET RETURN RATIO

Like all profit ratios, this is usually expressed as a percentage. It shows the return not on the issued capital but upon the real capital or stake of the proprietors. But what figure of capital should be taken? The figure we want is the

actual average effective capital employed in the business throughout the year. The balance sheet only gives us the capital figures at the opening and at the close of the year. Which figure shall we take, the starting capital, the ending capital or an average figure? In so far as any accretion of capital is due to accruing profits, it would be reasonable to take the mean figure on the assumption that profits have accrued evenly throughout the year. But increases in capital may also be due to further proprietors' capital invested in the business. In such cases the time of the year when such additions took place should be taken into account and the ratio computed accordingly.

Working upon Example XI, the net worth at the 31st March 1945 must be reconstructed in the light of the *A* and *B* revenue accounts, the balance sheet for that date not being available.

A		B	
	£		£
Final Net Worth .	138,600		138,600
Add decrease in carry forward 13,400—		Deduct increase in carry forward	
10,000	3,400	15,100 + 10,000 .	25,100
	<hr/>		<hr/>
Net worth 31/3/45 .	£142,000		£113,500
	<hr/>		<hr/>
(Assuming no fresh Capital introduced)			
Average Net Worth .	£140,300		£126,000
Net Profit <i>before</i> tax-			
ation	£56,600		£50,100
Net Return Ratio .	40%		38%

These figures correspond to 56.6% and 50.1% on the paid-up capital of the company.

As provisions for taxation may be affected by considerations other than the profits of the year in which they are made, the net return *before* taxation is the most reliable guide. Where this is unduly low it indicates over-capitalization or inefficient management, or both; or that, perhaps owing to competition, changing tastes or general depression, the business is no longer a profitable one. The net return is important because it gives an indication of the ability of the business to attract and remunerate fresh capital in case of need.

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To focus the reader's attention upon the difference between the inferences to be drawn from the balance sheet as at 31st March 1946 when read in conjunction with the *A* Revenue accounts and the *B*, the ratios deducted are tabulated below.

'MANUFACTURERS LIMITED'

ACCOUNTS FOR THE YEAR ENDED 31ST MARCH 1946

	A	B
1. Factory Gross Profit	46.5%	5.5%
2. Trading Gross Profit	24%	29%
3. Rate of Turnover of stock . . .	4.3 weeks	3.4 weeks
4. Creditor Ratio	6 weeks	1 week
5. Debtor Ratio	6.6 weeks	3 weeks
6. Stock Ratio (Factory)	6 weeks	5 weeks
7. Stock Ratio (Warehouse) . . .	5 weeks	2 weeks
8. Working Capital Ratio (Factory) .	19.4%	16.3%
9. Working Capital Ratio (Warehouse)	24.6%	11%
10. Net Return Ratio.	40%	38%

All the accounting ratios of the last group (Nos. 3 - 10 above) have one characteristic and basic weakness. They seek to establish a relationship between one or more balance sheet figures showing the position at a given moment of time on the one hand, and revenue account figures for a whole year on the other, thus:

<i>Ratio</i>	<i>Comparing Balance Sheet figure(s) for:</i>	<i>with Revenue a/c Figure</i>
Rate of Turnover	Stock (or average stock)	Cost of Sales
Creditor	Trade Creditors and Bills Payable	Purchases (excluding transfers from Works a/c)
Debtor	Debtors and Bills Receivable	Sales (or production)
Stock	Stock	
Working Capital	Working Capital	
Net Return	Net Worth	Net Profit

All the revenue account figures are totals for the whole year and as such may be taken as reliable. But there is no reason to suppose that the average weekly figure deduced from the totals would be correct for the closing weeks of the financial year, which alone have a natural and intimate connection with the position disclosed by the balance sheet

'Still'. It has already been suggested that the latter can only be considered in the light of the *immediate* preceding movements. If we were studying a golf swing with the help of a cinema projector, a 'still' at the moment of impact could usefully be studied in conjunction with the wind-up and the down-swing which immediately went before, or the follow-through which came immediately after, but would have no meaning at all in relation to sequences showing the player arriving on the tee, or moving off after his shot.

In relation to each of the balance sheet figures involved (for the working capital ratio the analyst will be using perhaps six or seven) the following questions must be asked:

- (1) How far is the figure itself accurate?
- (2) How far has it been affected (cf. the posed and unnatural photograph) by deliberate distortion?

and above all:

- (3) How far are the figures taken typical of those which have obtained for the same asset or assets throughout the trading period?

The last question is vital to the validity of all these ratios. Unless the balance sheet figures are near enough to the effective average for the whole year we shall offend against the axiom that like must be compared with like. Clearly in practice it is well-nigh impossible to establish either that the balance sheet figure taken is the correct one, or, in any case, that any ratio deduced will have any value in the forecasting of future developments.

The *Creditor and Debtor ratios* both suffer from two main defects:

- (1) The level of creditors or debtors at the balance sheet date is conditioned mainly by the buying and selling operations during the last few weeks of the year: if these were not at the average level for the year, the corresponding Creditors and Debtors figures will not be typical. Exceptionally high or exceptionally low purchases or sales just before the balance sheet date will substantially distort the ratios.

- (2) Nowhere in the accounts will it be disclosed how much of purchases or sales were on credit and how much for cash. In the absence of this information any inference as to the length of credit taken or given is untrustworthy.

The Debtors/Sales ratio is the more important of the two and deserves some further comment. Where sales during the year amount to, say, $4x$ and debtors to x , then the ratio is .25, indicating that the equivalent of 3 months' sales is tied up in book debts, though not probably or even necessarily the actual sales of the three months to the balance sheet date. Although the profit on these sales has been taken into account, it has not actually been received in cash. For we must remember that the Sales Ledger debits include all moneys owing and some of the debts may be of long standing. On the other hand, certain credit sales in the last three months of the account year may have been paid promptly, as little as a month after the sale took place.

A further important consideration is the proportion of cash to credit sales. It is obvious that if half the sales are for cash then a .25 ratio deduced from the accounts would mean that in fact the average Debtor tie-up is 6 months (ratio .5).

Nevertheless the ratio, taken in conjunction with the firm's credit terms, sheds some light on the efficiency of the accounts department and the quality of the debtors. Subject to the foregoing comments variations in the ratio from year to year can thus give a very useful suggestion of important changes both inside and outside the business.

Similar difficulties apply to stock, both in connection with the rate of turnover and the stock ratio with an added variable that the stock may not only be untypical in quantity, but also in the basis of valuation. That is to say, not only may the quantity of stock at the end of the year be lower (or higher) than the average, but by reason of recent market movements, may properly be valued at a figure lower (or higher) than the average cost for the year. Add to this the possibility that there may be deliberate undervaluation designed to throw profits forward to years when (it may be fondly hoped) taxation will be lower, and both the Stock/

Sales and the Stock/Turnover ratios begin to qualify for the rough-and-ready class. In special cases, however, the rate of turnover can be exceedingly useful.¹

The Working Capital ratio (Working Capital/Sales (or production)) rests on all the balance sheet items already discussed plus the liquid assets. It is subject to the characteristic defects of Balance Sheet/Revenue comparison which have already been fully discussed in connection with the Debtors/Sales ratio. As a rough and ready indication of the tie-up per £100 of sales or production, when the adequacy of available funds for contemplated expansion is being considered it is useful, however, and cannot be rejected merely because inferences to be drawn from it are provisional only. Whether they are sound or not can be tested by actual enquiry. In practice, the banker finds it most valuable when it enables him to say, 'Your security and general position would justify the advance of £10,000 for which you ask. On the showing of your own accounts, this will not provide sufficient working capital for your proposed £50,000 contract.' The onus of demonstrating that £10,000 is enough then rests upon the customer and his accountant. If in fact it is, well and good; and the proof will have taught the banker more about the inner workings of his customer's business than he could have learnt in any other way. The outstanding warning given by experience is this: the most carefully drawn budget tends to be falsified in practice and the wise banker will insist on a wide margin of available resources, either provided by the facilities granted, or by the greater sum he is prepared in his own mind to concede if and when it is needed.

The question of available resources leads to another related query: What is the ability of the business to attract fresh permanent share capital in case of need? On this question the *Net return ratio* sheds some light. The main purpose of this ratio is to determine whether further doses of capital can profitably be assimilated by the business. It must

¹ The writer had one case where stock appearing in the accounts at £6,000 had cost £36,000 and was worth at current buying prices not less than £45,000. Part of the undervaluation had been masked by the sale of a partnership business to a company. The rate of turnover – with all its defects – was so high as to positively invite an Inland Revenue investigation. The position was definitely vulnerable and an advance, which was in any case none too well secured, was refused.

always be remembered, however, that the current return on the net worth of the business will not necessarily be earned by additional capital. Sooner or later, perhaps much sooner than is expected, the law of diminishing returns will operate.

What has to be considered here is whether the net return ratio is a sound instrument in use. What of debenture or loan capital? Should not this be brought into the calculations? Set out below are skeleton balance sheets and Profit and Loss Accounts of a company making a trading profit of £3,000 and employing £10,000 of capital (either net worth or loan):

Let us now consider the effect of £5,000 increase in share capital with a proportionate rise in trading profit and overheads (ignoring possible diminishing returns for the moment).

Example XV

(1)

	Company		
	A	B	C
	£	£	£
<i>Balance Sheet Capital and Fixed Liabilities</i>			
Net worth	10,000	8,000	5,000
Bank Loan @ 5%	—	2,000	2,000
Mortgage @ 4%	—	—	3,000
	<hr/>	<hr/>	<hr/>
Total Proprietors' and Loan Capital .	£10,000	£10,000	£10,000
	<hr/>	<hr/>	<hr/>
<i>Profit and Loss Account</i>			
Overheads	2,000	2,000	2,000
Bank Interest	—	100	100
Mortgage Interest	—	—	120
Net Profit	1,000	900	780
	<hr/>	<hr/>	<hr/>
Trading Profit	£3,000	£3,000	£3,000
	<hr/>	<hr/>	<hr/>
Net Return Ratio Based on Net Worth .	10%	11.25%	15.5%

(2)

	Company		
	A	B	C
	£	£	£
<i>Increase of £5,000 in Share Capital</i>			
Net Worth	15,000	13,000	10,000
<i>Profit and Loss Account</i>			
Overheads	3,000	3,000	3,000
Bank Interest	—	100	100
Mortgage Interest	—	—	120
Net Profit	1,500	1,400	1,280
	<hr/>	<hr/>	<hr/>
Trading Profit	£4,500	£4,500	£4,500
	<hr/>	<hr/>	<hr/>
Net Return Ratio	10%	10.75%	12.8%

It is clear from the Example that:

- (a) Because the over-all return on the whole of the capital employed, i.e. 10% on £10,000 in case A, is greater than the rate of interest paid on the loan capital, the rate of net return on the net worth will be higher where loan capital takes the place of part of the share capital as in B and C.
- (b) Even where the trading profit increases *pro rata* the net return on new share capital will be lower than on existing net worth if there is any material amount of comparatively cheap loan capital. These difficulties disappear if the net return ratio is based on the total net worth plus loan capital, i.e. on £10,000 in (1) and £15,000 in (2) throughout. The net return rates will then be:

				A	B	C
(1)	Total capital	£10,000	.	10%	9%	7.8%
(2)	Total capital	£15,000	.	10%	9.3%	8.5%

indicating that the new capital in B and C will earn *higher* rate than existing capital has so far done. This is only what would have been expected, for the new capital earns its full basic rate without having to carry any of the interest charges. In fact, we have here a situation analogous to that of a company with considerable fixed-interest-bearing capital and a highly geared equity.

The ratio must therefore always be based on total net worth plus bank loans of a quasi-permanent nature and other loan capital. And with this proviso the net return ratio is a fair indication of what additional profit will be made to remunerate further equity capital. The following reservations must be kept in mind:

- (1) The additional capital may take considerable time before it brings in its full natural return.
- (2) The employment of additional capital may involve an increase in overheads, either higher in proportion than the increase in gross profit, or lower.

- (3) The profits for the year or years under consideration may have been raised or lowered by internal factors which no longer operate.
- (4) Changes in external conditions may make any forecast based on past figures completely wrong.
- (5) Where loan capital has to be brought into the calculation of the net return, the difficulty of establishing the true figure of capital employed will be obvious, particularly where fluctuating bank facilities are involved. Yet any relationship between a year's profits and the average capital employed in their making, cannot be logical unless the true effective figure can be determined.
- (6) The fact that the total profit for the year may have no relationship to the profits actually earned in its closing months or likely to be earned in the near future must be borne in mind.

The foregoing survey of the more usual financial relationships suggests that the only completely logical and valid ratio is the gross profit ratio. It states that on a year's sales, the figure for which is precisely known, the net profit (albeit determined partly by *estimates* for both opening and closing stock of all kinds) is a certain percentage. The net return ratio is similarly based on a true relationship, though the figure of capital may be difficult to determine with accuracy.

The rest of the ratios fall down as being based on comparisons between figures which are not strictly comparable at all. Nevertheless, they need not be discarded entirely by the banker who remembers at all times that:

- (1) a ratio by itself is almost valueless.
- (2) changes in ratios for different years can be exceedingly suggestive.
- (3) such changes or inconsistencies between trends indicated by different ratios are invaluable if they promote intelligent and searching enquiry.

- (4) ratios generally contribute most to the lending banker's armoury as mnemonics impressing upon his mind the kind of relationship between different items in the accounts which it is important to watch.

and finally that

- (5) when several ratios, each in itself of indifferent evidential value, all point in the same direction their combined verdict may be irresistible. How this works in practice will be seen when overtrading is discussed in a later chapter.

LENDING RATIOS

To complete the list of financial ratios it only remains to refer briefly to the two lending ratios which have been put forward by writers on bank advances. The first is the 2 to 1 current ratio popularized by Phillips and already discussed. The second is related to Net Worth computed after adjusting the book asset values to realizable values.

'What is the proper and safe relation between net worth, the proprietorship interest, or capital and surplus on the one hand, and *credit* worth on the other? It is maintained in banking circles that unsecured loans should not be made greatly to exceed one-third of the net worth, where the banker is well acquainted with the business, ability, and morals of the borrower. Nevertheless the ratio varies widely from banker to banker and from borrower to borrower. Even the bank balance¹ maintained by the applicant for a loan will be one of the determining factors. No hard and fast rule can be laid down.'²

It will be noted that both these ratios relate to unsecured borrowing and entirely ignore the way in which the advance will be used. If a temporary overdraft passes both tests it may not be far wrong; but the warning stands; there can be no hard and fast rules. Moreover there is much wisdom in the

¹ It must be borne in mind that in the United States bank advances by way of overdraft are illegal. They are normally taken on loan account against a promissory note with or without collateral.

² *Bank Credit*, C. A. Phillips.

old epigram 'There is nothing so permanent as a temporary advance'.

Phillips implies, rightly, that this lending ratio is only one of the factors to consider when assessing credit worth, the difference between one borrower and another being of paramount importance. The other factors in, and independent of, accounts which have to be considered will be discussed more fully in Chapter XIV.

CHAPTER X

CONSOLIDATED ACCOUNTS

Groups of companies – Requirements of the Companies Act – The purpose of Consolidated Balance Sheets – The principles of Consolidation – The purpose and nature of Consolidated Profit and Loss Accounts – Both designed for Shareholders – Validity for Creditors.

ACCOUNTING developments have usually derived from alterations in the nature of the underlying business and from the changing purposes which businessmen wish their accounts to serve. As industry and commerce have grown both in range and complexity, and the number of enterprises operating as joint stock companies has continued to increase, there has been a strong tendency for amalgamations of interests to be effected by the purchase by one company of a controlling interest in another or others.

The earlier method was a direct purchase of the assets and goodwill, the vendor, if a company, being placed in due course into members' voluntary liquidation. What, then, are the reasons for this change in practice; what are the advantages of the groups of companies which are so widespread today?

- (1) A controlling interest in another company may be secured without:
 - (a) incurring the expenses of amalgamation; or
 - (b) having to find sufficient cash to acquire the whole of the share capital or assets.
- (2) When shares are bought the expense of drawing conveyances and other documents of transfer is avoided. Share transfers in standard form will suffice.
- (3) The centralization of control of a group of undertakings is secured while maintaining their existing organizations, names and goodwill and – from the employees' point of view – without sacrificing loyalty to an established tradition.¹

¹ An advantage unwisely and quite unnecessarily lost when all the old railway names were abandoned for the uninspiring title of 'British Railways'.

The Companies Act, 1948,¹ has now withdrawn the advantage formerly available to a holding company of being able to conduct all active operations through private companies which, under the 1929 Act did not have to

- (a) file balance sheets with their annual returns;
- (b) issue balance sheets to members except when specially requested to do so at a shareholder's expense.

When groups of companies grew up the managements of really first-class holding companies started to present to their members consolidated balance sheets and sometimes consolidated profit and loss accounts. And now at last the legislature has stepped in to impose the best practice (or an effective substitute) on all holding companies.

The relevant sections of the Companies Act, 1948, are Nos. 149 to 154 and Part II of the Eighth Schedule. The main provisions are:

- (1) Definition of holding and subsidiary companies.²
- (2) Every holding company (unless itself the wholly owned subsidiary of another British company, in which case the position of its subsidiaries is of interest only to its own holding company) is required to produce to its annual general meeting, along with its own accounts, group accounts.³
- (3) Such group accounts must, with certain exceptions, be in the form of consolidated balance sheet and consolidated profit and loss account⁴ which must comply, as to form and content, with the Eighth Schedule.⁵
- (4) Group accounts must give a true and fair view of the state of affairs and the profit and loss of the holding company and its subsidiaries as a whole, as far as concerns the members of the company, and must be so certified by the holding company's auditors.⁶
- (5) Where a consolidated balance sheet and a consolidated profit and loss account are produced (provided such profit and loss account discloses how much of the group profit is dealt with in the accounts of the

¹ Sec. 129 and 7th Schedule.

² Sec. 150.

³ Sec. 152.

⁴ Sec. 154.

⁵ Sec. 151.

⁶ 9th Schedule, para. 4.

holding company) the holding company need not lay its own profit and loss account before its members in general meeting.¹

In view of the emphasis which has been placed in Chapter VI on the importance of reading the balance sheet, which is now available with last year's figures alongside for comparison, with the revenue accounts which link the two balance sheets, it is to be deprecated that under this last provision the shareholders and creditors of a holding company may, as regards that company (though not as regards the group as a whole) be deprived of this valuable source of information. Many holding companies, following the best accounting practice (which is still in many respects in advance of the minimum legal requirements) continue to publish both their own and a consolidated profit and loss account. Where this is not done the banker should be alive to the necessity in all suitable cases for calling for the holding company's own profit and loss account where that company is his borrower: or better still, for the complete revenue accounts.

The structure of consolidated accounts is an important branch of the new accountancy and must therefore be added to the ever widening fields with which the lending banker must make himself familiar. The aim of this chapter is not, however, to discuss in detail the intricate mechanics of consolidation, but to arrive at an appreciation of the results and to grasp the realities which group accounts represent. For this purpose a summary of the main principles only will suffice.

CONSOLIDATED BALANCE SHEETS

The purpose of a consolidated balance sheet is to show the holding company's members the position of the group as a whole, *vis-à-vis* the outside world. Accordingly:

- (1) Inter-company debts and inter-company acceptances are cancelled out.²

¹ Companies Act, 1948: by inference from Sec. 149, (5).

² There is one exception to this. If any inter-company acceptances have been discounted there will no longer be an item 'Bills Receivable' in one balance sheet to set off against the item 'Bills Payable' in another. The latter item is therefore retained in the consolidated balance sheet. The liability of the group being thus fully shown, the now superfluous note regarding the contingent liability is omitted.

- (2) Stock which was purchased by one company in the group from another in the group is reduced in value to its initial cost to the vendor company, whose profit on the sale is similarly reduced. It is of course quite proper for that profit to be shown in the individual accounts of the vendor company. But looked at *from the point of view of the group*, no profit will have been earned merely by the transfer of goods from one stock-room to another within the group; a sale must take place outside the group before it can be said to have earned a profit.
- (3) Any profit realized on the sale of a fixed asset within the group is similarly eliminated from the consolidated balance sheet, if the asset is still held within the group at the balance sheet date. The item will thus appear in the consolidated balance sheet at its initial cost, not at re-sale cost.

The method of consolidation as at the date of acquisition is, briefly:

- (1) To use the holding company's balance sheet as the framework for the consolidated balance sheet:
- (2) To bring in, in place of the asset 'Investments in Subsidiary Companies' the actual assets and liabilities as at the date of acquisition (excluding 'Net Worth' items) from the balance sheets of the subsidiaries, the amounts of which represent the respective investments. It will be clear that a subsidiary's reserves and profit and loss balances *as at the date of acquisition* will not appear as such in the consolidated balance sheet. This follows from the fact that profits and surpluses already earned by subsidiaries are not profits or surpluses from the point of view of the group.
- (3) To make an adjustment, necessary to ensure that the consolidated balance sheet balances, where the net assets brought in do not exactly correspond in amount to the investment figure replaced. The adjustments are as follows:

- (a) where the net assets brought in exceed the investment figure, a balancing 'Consolidation Reserve' or 'Capital Reserve' is introduced into the consolidated balance sheet. This is similar to the reserve which is created when a capital asset is revalued and its book value is written up. In fact that is exactly what has happened. The item is often accompanied by some such explanatory words as, 'being excess of the appropriate proportion of book values of net assets of subsidiaries at dates of acquisition of shares therein, over the cost, less amounts written off, of such shares';
 - (b) where the investment figure exceeds the amount of net assets brought in, there will be a shortfall on the assets side of the consolidated balance sheet. To make this good a goodwill item is created, either increasing existing goodwill balances or, better still, a balancing item is introduced. 'Excess cost of shares in subsidiary companies over the book value of the net assets acquired.'
- (4) Where the holding company holds less than 100% of the share capital of a subsidiary, say 80%, it would obviously be incorrect to bring in 100% of the subsidiary's assets and liabilities. There are two ways of dealing with this difficulty:
- (a) to bring into the consolidated balance sheet only 80% of the appropriate liabilities and assets;
 - (b) to bring in the full liabilities and assets, and include a special liability item, 'Minority shareholdings in subsidiary companies and reserves and undistributed profits attributable thereto'.

The second method is preferable since it makes possible the retention in the consolidated balance sheet of the total assets controlled by the holding

company and discloses both the existence and extent of an accountability to shareholders outside the group.

CONSOLIDATED PROFIT AND LOSS ACCOUNT

While the purpose of the consolidated balance sheet is to show the shareholders of the holding company the position of the group *vis-à-vis* the outside world and the growth of the undertaking's net assets compared with the year before, the consolidated profit and loss account is designed to show the shareholders the total profits which have contributed to that growth, and which are available from all its interests (including its own trading) to the holding company. It must, therefore, exclude the following things:

- (1) Pre-acquisition profits of subsidiaries which, having been allowed for in the price of acquisition, will be treated as a capital and not a revenue credit. For example, on 10th June 1951 Company 'A' buys an 80% interest in the share capital of Company 'B', which is all in the form of ordinary shares. The accounts of both companies are made up to 31st December 1951 and Company 'B' discloses a net profit of £16,000 for the year. Of this amount:

20% = £3,200 is attributable to minority interests.

$\frac{161}{365\text{ths}}$ = £5,646 is attributable to pre-acquisition profits
of arising out of A's interest.
80%

$\frac{204}{365\text{ths}}$ = £7,154 is attributable to post-acquisition profits
of arising out of A's interest.
80%

Only the £7,154 is true group profit to be brought into the consolidated profit and loss account of Company A and its subsidiaries. The £3,200 will be included in the balance sheet with the appropriate part of the capital, reserves and profit and loss balance at 31st December 1951 under the item 'Interests of the minority shareholders'.

The new legislation has materially tightened up the

position regarding holding companies and their subsidiaries. The definition of a subsidiary company has been widened to include sub-subsidiaries which were omitted under the 1949 Act.¹ But a Company D, 50% of whose equity capital is held by each of Companies B and C, which are in turn subsidiaries of Company A, still escapes, even though, through its own subsidiaries, Company A controls the whole of the equity of Company D. There is accordingly no obligation to include the accounts of Company D in the group accounts even if in fact the whole of the group's real activities were conducted by D.

There are still more than enough ways in which the intention of the legislature, which is to give to the holding company's shareholders adequate information about the group's affairs, can be defeated.

THE BANKER'S APPROACH

The lending banker, as a creditor, has an approach quite different from that of the shareholders, and our present purpose is to enquire how far consolidated accounts help him as a creditor of a holding company.

The balance sheet of his borrower may show as a substantial, perhaps as its main, asset investments in and advances to subsidiary companies. His problem is to determine the real value of these assets and especially the true current position of the company. How far can the consolidated accounts furnish the answer?

There are three aspects of consolidated accounts with which the lending banker is especially concerned.

(1) The limitations which affect all accounts are present to at least the same extent in all consolidated accounts with the added possibility that a consistent basis of valuation may not have operated throughout the group.

(2) Consolidated accounts are designed primarily for the information of *shareholders* of the holding company.

(3) They relate to a notional integration of companies which, in fact, remain separate legal entities; the creditors of any one company can look for the payment of their debts to

¹ Sec. 127.

the assets of that company alone. The group as such has no legal existence.

The last two aspects merit further examination.

GROUP ACCOUNTS DESIGNED FOR SHAREHOLDERS

The Companies Act, 1948, underlines the lessons of accounting history that group accounts are intended and designed for the information of shareholders only when it provides that the group accounts laid before a company in general meeting shall give a true and fair view of the affairs of the group 'so far as concerns the members of the (holding) company'.¹ This aspect is strongly emphasized by the sections permitting the directors of a holding company to omit the laying of group accounts with its own if they are of the opinion that, in the case of any subsidiary, group accounts would be of no value to the members of the holding company;² or to present group accounts in a form other than that of consolidated balance sheet and profit and loss account, if they are of the opinion that the necessary information may be better appreciated by their members if presented in some other form.³ In each case the sole criterion is the interests of the shareholders. Neither the legislature nor the accountancy profession is here concerned with creditors and others having dealings with the holding company.

A GROUP NOT A LEGAL ENTITY

Robson admirably sums up the position. 'The underlying theory, which has much to support it, is that inasmuch as in essence such a group constitutes one business, although carried on in branches which are separate entities, its affairs and earnings can properly be viewed as those of one undertaking from the standpoint of the shareholders in the holding company. . . . The consolidated accounts represent an endeavour to show the position and earnings in a manner as near as is possible to the way in which they would appear in the holding company's own accounts if, instead of owning shares in a number of subsidiary companies . . . the holding

¹ Companies Act, 1948, Sec. 152 (1).

² *ibid.*, Sec. 150 (2) (b) (i).

³ *ibid.*, Sec. 151 (2).

company were to own directly the assets and businesses and bear responsibility to the creditors of and other financial interests in the subsidiary companies.'

'Such an endeavour must obviously be inadequate as a disclosure of the position to the creditors of any one of the companies. . . . But it is not intended to be used for that purpose. . . . Outside interests in these companies must look to (such companies') separate accounts rather than to the consolidated statements for information as to the assets representing their interests or claims against the individual companies.'¹

The study of an actual set of group accounts will take the reader some way along the track of discovery. It should show not only the main principles of consolidation in practice but assist towards an appreciation of the perhaps limited significance of a consolidated balance sheet to a creditor of, or a lender to, the holding company.

Example XVI comprises the following items:

- A. The balance sheet of a holding company in simple form.
- B. Consolidated balance sheet of the group on the same date.
- C. A consolidated balance sheet of the subsidiary companies only, derived mainly by deducting the figures in A from the figures in B. A footnote explains the more complicated method of computing the net worth figure: the actual figures for the share capital of the subsidiary companies cannot, of course, be extracted from A and B.
- D. Shows the computation of all the figures in the consolidated balance sheet affected by the existence of either minority interests or pre-acquisition profits and reserves. This computation in conjunction with the relative balance sheets will help the reader to a real understanding of the points involved.
- E. The simplified balance sheets of the three subsidiaries.

APPRAISING THE CONSOLIDATED BALANCE SHEET

While the apparent net worth in A is high, amounts invested in or lent to subsidiary companies represent over three-quarters of the total assets. The strength of the company, in so far as it can be disclosed by the balance sheet, therefore stands or falls by the value of these assets.

¹ *Consolidated and other Group Accounts*, T. B. Robson.

TRICOLOUR (HOLDINGS) LIMITED and its SUBSIDIARY COMPANIES

CONSOLIDATED BALANCE SHEET, 30TH SEPTEMBER 1951

<i>Capital:</i>	£	£	<i>Excess Cost of Shares in Subsidiary Com-</i>	£
£1 fully paid ordinary shares . . .	300,000		ppanies over Net Assets at date of acquisition	64,219
<i>Reserves:</i>				
General Reserves	86,000		<i>Fixed Assets at cost less amounts written</i>	
Profit & Loss Accounts	24,147		off	265,691
	<hr/>		<i>Current Assets:</i>	
<i>Interest of Outside Shareholders in Sub-</i>		410,147	Work-in-Progress	97,905
sidiary Companies		37,551	Stock	72,170
<i>Loan Capital:</i>			Debtors	108,385
5% 10 Year Notes	35,000		Cash at Bank	82,304
6% Debenture Stock	20,000			<hr/>
	<hr/>	55,000		360,764
<i>Current Liabilities:</i>				
Sundry Creditors	145,195			
Bank Overdrafts	42,781			
•	<hr/>	187,976		
		<hr/>		
		£690,674		<hr/> £690,674

Example XVI

C
CONSOLIDATED BALANCE SHEET OF THE SUBSIDIARIES OF
TRICOLOUR (HOLDINGS) LIMITED

30TH SEPTEMBER 1951

<i>Capital, Reserves and Profit and Loss Account</i>	£	£		£
<i>Balances</i>	.	.	<i>Fixed Assets, at cost less amounts written off</i>	.
6% Debenture Stock	.	1291,614		.
<i>Current Liabilities:</i>	.	20,000	<i>Current Assets:</i>	.
Due to Holding Company	.	57,854	Work-in-Progress	.
Sundry Creditors	.	111,309	Stock	83,476
Bank Overdrafts	.	42,781	Debtors	68,578
			Cash at Bank	89,431
				74,382
		211,944		315,867
				<u>£523,558</u>

¹ Ascertained as follows:

Investment in Subsidiaries	£
(From Holding Company's Balance Sheet)	297,355
Excess of Consolidated Balance Sheet figures over Holding Company's figures for:	
Reserves	16,000
Profit and Loss Accounts	4,927
Interest of Outside Shareholders from Consolidated Balance Sheet	37,551
	<u>355,833</u>
LESS Excess cost figure from the consolidated balance sheet	64,219
	<u>£291,614</u>

Example XVI

D
COMPUTATION ON CONSOLIDATION OF FIGURES FOR RESERVES, PROFIT AND LOSS ACCOUNT,
OUTSIDE SHAREHOLDERS' INTEREST AND EXCESS COST

(The Holding Company has an 80% interest in Redwing Limited; the other Subsidiary Companies are fully owned)

Details	As at date of acquisition	Post acquisition	Acquired by Holding Company	Reserves	Profit and Loss Account	Outside Shareholders (20% interest) in Redwing Ltd.
CAPITAL						
Redwing Ltd.	£ 100,000	£ —	£ 80,000		£	£ 20,000
Whitlock Ltd.	50,000	—	50,000			
Bluestone Ltd.	75,000	—	75,000			
RESERVES						
Redwing Ltd.	40,000	20,000	32,000	16,000		8,000
PROFIT AND LOSS						4,000
Redwing Ltd.	15,823	11,929	12,658		9,543	3,165
Profits			5,832		1,512	2,386
Bluestone Ltd.	5,832	1,512				
Profits						
DEDUCT						
Whitlock Ltd.	22,354	6,128	255,490		11,055	
Losses			22,354		6,128	
ADD						
Tricolour (Holdings) Ltd.			233,136	70,000	4,927	
	Cost of acquisition of shares in Subsidiaries		297,355		19,220	
	Figures carried to Consolidated Balance Sheet . . .		Excess cost			
			£64,219	£86,000	£24,147	£37,551

Example XVI

三

REDWING LIMITED

BALANCE SHEET, 30TH SEPTEMBER 1951

<i>Capital</i>	£	100,000			<i>Fixed Assets</i>	£	54,985
<i>Reserves</i>	£	60,000			<i>Loan to fellow Subsidiary</i>	£	12,543
<i>Profit and Loss</i>	£	27,752			<i>Other Current Assets:</i>		
			187,752		Work-in-Progress	6,211	
					Stock	7,972	
					Debtors	47,492	
					Cash at Bank	74,382	
<i>Creditors</i>			15,833				136,057
							<u>£203,585</u>

WHITELOCK LIMITED

BALANCE SHEET, 30TH SEPTEMBER 1951

[illegible]

The current position – of prime importance to the banker – is not very strong and certainly not very liquid, unless the advances to subsidiaries are both good and liquid.

What light does the consolidated balance sheet (B) throw on the position?

(1) It is seen for the first time from the 'Interest of outside shareholders' items, that at least one of the subsidiaries is not wholly owned by Tricolour (Holdings) Limited.

(2) There is a substantial excess cost or goodwill 'asset' which may or may not be justified by the true value of the assets.

(3) Nevertheless net worth is substantial and the balance sheet is on the face of it sound.

(4) Both Bank Overdrafts and Bank Credit Balances appear. In consolidating the accounts the quite usual practice of setting off the overdrafts of certain companies in the group against the credit balances of others and showing a net figure only has not been followed. No such right of set off will exist in fact even where all the companies bank with the same bank. To quote a net figure would therefore seem contrary to the requirement that the consolidated accounts must present a true and fair view of the affairs of the group. Similar considerations arise where any outside creditor of one company in the group is at the same time the debtor of another. Unless there is some right of set off specially created by agreement or by process of law (e.g. a garnishee order) the accounts should reflect the underlying realities and show the figures as the independent liabilities and assets which in fact they are.

(5) The current position is both strong (Ratio 1.92) and reasonably liquid. Debtors and Cash combined exceed current liabilities. The fact that Creditors exceed Debtors (Drs./Crs. Ratio .75) may require explanation.

Nevertheless the general impression conveyed by the consolidated balance sheet is one of satisfactory balance and reasonable strength. Can this impression be trusted? Does the consolidated balance sheet represent (albeit imperfectly as a balance sheet must) any underlying reality which has meaning for and can give assurance to a lending banker or other creditor of the holding company?

The answer is required to two questions: the value of the holding company's investment and the soundness of its loans to one or more of the subsidiary companies.

With regard to the first, the consolidated balance sheet does disclose that the price paid for the shares of subsidiary companies exceeded the book values of the net assets acquired to the extent of £64,219 and unless there is a substantial goodwill value or an undisclosed reserve concealed by the undervaluation of the assets of subsidiaries *prima facie* too much has been paid. But in fact the consolidated balance sheet can help little as to the value of the holding company's investment.

What of the loans and advances? It must be remembered that inter-company indebtedness has been eliminated and the whole of the current liabilities which remain are due to persons outside the group. But this elimination is based solely upon the hypothesis that the group is one entity and that there is no greater difference between the component parts of the group than there is between the separate departments of one business. This is a complete fallacy and no outside party who is owed money by one of the constituent companies can look for satisfaction of his debt beyond the assets of that company; certainly not to the assets of any other company in the group. The consolidated balance sheet has therefore failed to answer the legitimate questions of the creditor simply because it is based not upon reality but upon a notional approach valid only for the members of the holding company: and not even fully valid for them. It is accordingly necessary to fall back upon the individual balance sheets of the subsidiary companies themselves which, it should be noted, a member of the holding company is not entitled to receive and which a creditor of the holding company will never have access to (except belatedly on the files of the companies' Registry), unless his position is sufficiently strong to enable him to insist on their production.

From the three subsidiary balance sheets themselves it will be seen that real capital of £254,063, made up as follows (but with no direct indication of the extent of pre-acquisition reserves and profits):

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REDWING LIMITED	£	£
		187,752
WHITELOCK LIMITED		
Capital	50,000	
Less Profit and Loss account deficit	28,482	
		21,518
BLUESTONE LIMITED		82,344
		291,614
Less Outside Interests		37,551
		<u>£254,063</u>

was acquired on the investment of £297,355 by the holding company, but there is still no indication which companies are wholly owned or which are the subject of extra-group interests. The value of the investments in the subsidiary companies remains as elusive as ever, especially as the one figure in the holding company's balance sheet gives neither the amount invested nor the extent of the interest in the individual companies.

What of the value of the £57,854 advanced to subsidiary companies? Of this, £37,854 is due from Whitelock Limited, whose balance sheet discloses an extremely weak current position with total current liabilities (including the holding company's loan) plus bank overdraft at £93,874 more than double the current assets £41,602. This loan has, therefore, all the appearance of a lock-up.

The balance of the advances is to Bluestone Limited £20,000 (£32,543, less £12,543 borrowed from Redwing Limited). Here the current assets exceed the current liabilities (Current Ratio: 2) but are predominantly unliquid and again the loan must be regarded as a lock-up.

This position could not have been deduced from the consolidated balance sheet at all, which is indeed not only an unsatisfactory source of information to the lending banker, but is sometimes (as in this case) positively misleading.

As far as day-to-day control is concerned, the holding company is certainly in a position to secure the utilization of the resources of Redwing Limited to repay its own loans

to the other two subsidiaries or to discharge the latter's or its own heavy current liabilities. Whether the directors of Redwing Limited can properly utilize that company's funds in this way is quite another question. They are in a fiduciary position charged with the duty of conducting the company's affairs and controlling its resources in the interests of the company as a whole. They are not entitled as a matter either of law or ethics to exercise their powers for the benefit of any other company, nor for the exclusive benefit of 80% of the shareholders (i.e. the holding company) to the detriment of the 20% minority. It will be interesting to see whether such possible misuse of directors' powers will be curbed by the new rights given in Section 210 of the Companies Act, 1948, or whether the notorious apathy of shareholders will render this valuable safeguard nugatory. This section provides *inter alia* that any member of a company who complains that its affairs are being conducted in a manner oppressive to some part of the members (including himself) may petition the Court which has the widest power to make such order as it thinks fit whether for regulating the company's affairs in future or otherwise. And even where a subsidiary company is wholly owned the misuse of its funds for the benefit of its holding company or the latter's subsidiaries may, if loss is caused thereby, amount to a misfeasance or breach of trust in relation to the company which, under Section 333, will render the director or directors concerned liable to make restitution on the liquidation of the company.

Whatever doubts there may be as to whether the directors of a holding company can make available the resources of the group to meet its own liabilities, there can be little doubt as to the inability of a creditor to achieve the same result in his own right and by his own actions. From the point of view of a creditor of the holding company, Tricolour (Holdings,) Limited, its directors might, but certainly cannot be made to, make available the resources of Redwing Limited to satisfy his debt.

A receiver appointed by the creditor under his debenture could borrow such resources, but could only do so by incurring a liability to repay which he would have to discharge and the creditors would not be advantaged. If no debenture is

held and liquidation of the holding company is forced the shares in the subsidiaries would be sold but the direct use of the subsidiaries' resources would be almost impossible; the liquidator would have the utmost difficulty in forcing the liquidation of the subsidiaries and the distribution of their assets to himself as shareholder.

All this adds up to the conclusion that any banker who lends or is asked to lend to a holding company must beware of being misled by strength in the group which is out of his reach. Before reading a consolidated balance sheet he should say to himself 'This balance sheet is what would be produced if the whole groups were one legal entity. It is only correct, it only has meaning on that assumption: *the assumption is never valid*'. With this caveat in mind the banker can then look to the consolidated balance sheet for indications of progress in the groups as a whole which indirectly and on long term will enure for the benefit of the holding company. He will not delude himself that it can tell him very much else.

In the face of this conclusion there must be some cause for regret at the vogue now enjoyed by consolidated accounts – which can be so misleading to the lending banker and other creditors – following the blessing of the legislature.

CONSOLIDATED PROFIT AND LOSS ACCOUNTS

How far do the foregoing reservations apply to group revenue accounts? Example XVII is a typical Consolidated Profit and Loss Account which shows what profits, attributable to the interests of the holding company have been made during the year, how they have been dealt with and the extent to which they are held by the holding company and by the subsidiaries, respectively. They therefore do exactly what they purport to do – no more, no less: the whole of the unappropriated profits disclosed, after the portion attributable to outside shareholders has been allowed for, are available and ultimately distributable to the members of the holding company. This is of course subject to normal financial prudence and in this respect a consolidated profit and loss account is no different from that of an individual company. The Consolidated Profit and Loss Account may therefore be accepted as valid.

TRICOLOUR (HOLDINGS) LIMITED AND ITS SUBSIDIARIES
CONSOLIDATED PROFIT AND LOSS ACCOUNT, YEAR TO 30TH SEPTEMBER 1951

	£	£	Surplus from Trading Income from Investments:	£	£
<i>Interest on Loan Capital (Gross)</i>	.	.	.	.	76,666
<i>Directors' Emoluments:</i>					
Fees	2,000	.	Trade	10	
Other	11,833	.	Other	189	199
<i>Auditors' Remuneration:</i>					
Parent Company	42	.			
Subsidiary Companies	170	.			
<i>Taxation on Profits of the Year:</i>					
U.K. Income Tax	15,328	.			
U.K. other	7,477	.			
<i>Attributable to Outside Shareholders:</i>					
Proportion of Profit for the year					
Surplus for the Year (Note (i))					£76,865
<i>Transfers to Specific Reserves</i>					
<i>Subsidiary Companies:</i>					
Appropriations	4,836	.	Surplus for the Year	20,000	31,147
Carried forward	4,927	.	Items relating to previous year:		
			Taxation adjustments	943	
			Provisions no longer required	2,438	
<i>Parent Company:</i>					3,381
Balance forward (Note (ii))		.	Balance from previous year		14,455
					£48,983

Note (i). This is the year's surplus attributable to the Group.

Note (ii). Carry forward, corresponding to Profit and Loss Balance in Holding Company's Balance Sheet: with subsidiaries, carry forward (previous item) corresponds to Consolidated Balance Sheet Profit and Loss balance.

CHAPTER XI

VARIOUS BALANCE SHEETS

Two Farming Balance Sheets — Professional Partnership — An Association — A Plantation Company — Extractive Company — Dyeing Company — Mining Investment Company — Hire Purchase Company — Chain Store Company.

THE varied balance sheets considered in this chapter have been selected to fulfil three main purposes:

- (i) to show that all balance sheets have the same basic structure and are susceptible to the same kind of analysis;
- (ii) to familiarize the reader with balance sheets of non-industrial undertakings;
- (iii) to provide the opportunity of making comments on any special features of interest both from the accounting and banking angles. In the course of these comments it is hoped that some understanding of the kinds of inference which can be safely made will grow.

For reasons which are dealt with fully in Chapter XIV, no attempt whatever will be made to indicate how much bank accommodation would be justified by these different balance sheets.

For the convenience of the reader the specimen balance sheets have been folded in at the back of the book and can be extended one at a time for study in conjunction with the relative comments.

BALANCE SHEET A SOLE TRADER : TFNANT FARMER BALANCE SHEET PERCENTAGES

Real Capital	28.3%	Fixed Assets	55.4%
Current Liabilities		Current Assets	44.6%
Bank	32.7%		
Sundry Creditors	39.0%		
	<u>71.7%</u>		
	<u>100.0%</u>		<u>100.0%</u>
Current Ratio . . . . .	.62	Liquid Ratio	Nil.

Real Capital provides 51% of the fixed assets: 49% of the fixed assets and all the current assets are provided by creditors; on the face of it, a very vulnerable position.

Net Profit—10¼% on turnover: 12% on total assets
(before tax) employed at the end of
the year: 42% on net worth.

Though a farm house and ample cottages are owned the farm lands, which must be extensive, are obviously rented. The business looks seriously under-capitalized and there seems little doubt that Mr. Farmer must have substantial means outside his farming assets. The size of the bank overdraft suggests that outside security must be held: and, taken with the high creditors, suggests a financial standing not revealed by the balance sheet itself.

At the end of March one would normally expect a stock or arable farmer to be in a reasonably liquid condition with last year's harvest sold and his stock beginning to build up. The fact that crops and cultivations account for no less than 90% of the valuation, suggests further enquiry. The revenue accounts show:

	£
Sales of Cattle and Sheep	4,152
„ Wheat, Oats and Barley	23,136
„ Sugar-Beet	5,982
„ Market Garden Produce	47,928
„ Hay and Straw	393
Total Sales	81,591
Grants	3,840
Contract Work	2,528
Tenant Right	351
	<u>£88,310</u>

The main activity being Market Gardening, the cultivations may include a substantial amount for early garden produce, which will bring in quick and substantial cash.

The balance sheet shows totally inadequate proprietor's capital, though if enquiry confirms that the bank overdraft is fully covered by security put up by the farmer, his real stake (albeit partly indirect) comes up to the more satisfactory proportion of 61% of the total funds employed. Even on this

basis the bank advance has all the appearance of permanent capital. But profits are substantial while drawings are negligible—further evidence of outside means—and even allowing for tax liabilities which are not usually reserved for in a private trader's accounts, capital should build up and bank borrowing fall.

The recent heavy expenditure on plant and machinery suggests (if the expenditure was wise) that the farm is in the early stages of modernization. If so, the $10\frac{1}{4}\%$ net profit rate on total production may well be improved on possibly a higher out-turn: and there may be scope for extending profitable contract work. The high creditor figure may include substantial amounts not in respect of normal current purchases but of fixed assets bought on credit, some of it on Hire Purchase Accounts. The banker will be curious about all these matters.

He will be interested, too, in the acreage farmed broken down to show the extent of use for arable, pasture, horticulture, rough grazing and woodland and to see how the effective acreage compares with the capital employed. If the number of cattle (ascertained by dividing a fair average price into the valuation figure) indicates an overloading of the pasture, further enquiry may reveal any of the following things:

- (i) that there was actual over-stocking at the balance sheet date;
- (ii) that pedigree herds are carried and the fair average price applied was, in fact, too low;
- (iii) that at peak periods additional pasture is rented.

Well drawn revenue accounts shed valuable light on the type of farming carried on. But in no industry is it less safe to rely on accounts alone. If factories should be seen, farms and farmers should be visited and known intimately. The difference between 'farming to quit' and keeping the land in good heart will often not show on the face of the accounts. It is obviously vital for a banker to know whether satisfactory profits are 'the result of good husbandry or of 'bleeding' the land.

BALANCE SHEET B

FARMING COMPANY

BALANCE SHEET PERCENTAGES

Real Capital	% 6.5	Fixed Assets	% 20.9
Loan	45.6	Current Assets	79.1
Effective real Capital	52.1		
Bank Overdraft	31.8		
Current Liabilities	16.1		
	<u>100.0</u>		<u>100.0</u>

Current Ratio 1.65

(Taking overdraft as a wholly current liability)

Liquid Ratio Nil

The effective real Capital (including the loan)
is invested 40.1% in fixed Assets
59.9% in current Assets

100.0%

Net Profit—10.9% on Turnover.

12.3% on total Assets employed at end of year.

The Capital structure of this tenant company (no land is owned) is suggestive. The main capital has been put up by way of loan, rather than subscribed Share Capital, to keep the position flexible though not for the more usual reason of saving capital duty, for this has already been paid on the Authorized Capital of £18,000. The bank will probably have taken a letter of postponement¹ to place the loan at the back of the queue, along with the Issued Share Capital. Losses have been made in the past, but the profit rate is now reasonably good in relation to both turnover and total assets employed. Compared with Balance Sheet A, fixed assets are low, and it is a fair inference (which the trading account will confirm) that the main activity is dairy-farming and stock raising, with just sufficient arable farming to provide fodder, give the pastures a rest and, incidentally, earn the subsidies.

It is usual for all farm accounts (whether of companies or sole traders) to have the valuation of stock made by a professional valuer. 'Tenant right' corresponds to work-in-progress in an industrial balance sheet, and is based on

¹ See explanation at page 238 *post*.

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expenditure incurred in ploughing, manuring, seeding and the like for which, had the tenant relinquished possession on the balance sheet date, he would have been entitled to compensation as part of the new tenant's ingoing: a proportion of rent and other overheads can reasonably be added. For an owner-farmer the corresponding term should strictly be 'cultivations': but as the basis of valuation is the same in either case, the terms are usually regarded as interchangeable. As in industrial accounts an increase (reduction) in cultivations or tenant right is added to (deducted from) sales to ascertain the true turnover.

BALANCE SHEET C			PROFESSIONAL PARTNERSHIP		
BALANCE SHEET PERCENTAGES					
Real Capital	.	57.3%	Fixed Assets	.	5.9%
Current Liabilities	.	42.7%	Current Assets	.	94.1%
		<u>100.0%</u>			<u>100.0%</u>

Current Ratio 2.2 : Liquid Ratio .9

Real Capital, comprising Capital and Drawings Accounts, covers the comparatively small fixed assets and 44% of the Current Assets.

Net Profit is 42.4% of total out-turn: and 59.4% on capital employed at end of year.

It will be noted that unlike most commercial and industrial balance sheets, this one lists the assets in order of payability, with current liabilities first and proprietors' claims last: and the assets in order of liquidity, from cash to goodwill. Banks and other financial institutions which wish to emphasize their liquid strength above all else, often follow the same course. The large provision for income tax is a reminder that this tax is always payable by a partnership and not by the partners personally, even though the amount assessed is based on their individual returns.

The tie-up in debtors, accrued fees ('work-in-progress') and expenses not yet charged up is high in this type of practice: in this case it is equivalent to 75.6% of the year's turnover. Liquid Assets at £60,000 look ample until it is seen that practically the whole of this amount is due (in the case of Income Tax, overdue) to be paid out at once:

Income Tax 1952-3	£16,816	(payable 1st January 1953)
Staff Bonus	11,226	
Estate of Deceased Partner	24,573	
	<u>£52,615</u>	

Sundry creditors have nearly doubled and may contain a sufficient overdue element to absorb the balance of the liquid assets at an early date. It is also noteworthy that the Current Assets have become much less liquid in character. Accounts immediately receivable are little over half those at the end of the previous year, while the amounts tied up in fees and expenses not yet chargeable, are nearly £20,000 higher. In fact a close examination reveals a position of near stringency: and part of the reason.

G. H. Parker's capital and drawings account balances amounting to £31,400 have been lost to the business and £7,000 in cash has already been paid out. The last remnant of a similar cash drain to another deceased partner is indicated in the 1952 figures (Estate of C. C. Faull, dec., £978). In fact, during the past ten years, nearly £110,000 has been paid out to deceased or retiring partners: and, in the absence of private capital (which high taxation has made it difficult to accumulate), has had to be found out of an enforced under-drawing of profits by the remaining members of the firm. The drawings accounts of the three surviving partners have been augmented during the year, by no less than £19,000, but there is still a long way to go before the loss of G. H. Parker's capital in the firm is made good. The paying out of a deceased partner, like the payment of taxation, requires cash and thus falls on the business where it hurts most. It will be noted that the drawings account balances of two out of three of the partners already stand higher than that of G. H. Parker at his death; and a further build up, inevitable if the remaining £24,500 due to G. H. Parker is to be covered, will exacerbate the problem of the survivors still more when the next partner dies or retires.

The payments to Watson £1,920, represent part of the purchase price of another practice. As it is clearly the intention to charge the cost up to partners' drawings accounts and not to leave this item in the balance sheet capitalized as

'Goodwill', there seems little point in showing this item in the balance sheet at all.

Turning to the revenue account (which for the reader's convenience is barred off into three sections to correspond with the Trading, Profit and Loss and Appropriation Accounts of a trading company) the high profit rate 42.4% is noteworthy though not at all excessive where personal expert service is being sold and its cost is not directly charged against profits. The lower divisible profit on a higher out-turn (10% up) prompts enquiry which discloses that a branch recently opened in the Middle East has lost money during the year.

Nevertheless the overall position is so strong, the earnings so high, and above all, the ploughing back of profits so large that the request for occasional overdrafts up to £5,000 (in connection with which these accounts were produced), was agreed to without hesitation. An important factor was recent interlocking life insurance (partners A and B holding policies on the life of C, and so on) to meet the embarrassments of a further death in the firm.

BALANCE SHEET D

CLUB, OR SIMILAR INSTITUTION

This is a typical balance sheet for a professional institute, club or similar body. The freehold premises are no doubt held by Trustees on behalf of the association. The only item which calls for comment is the Accumulated Fund which corresponds to Members' Capital and with the Reserves constitutes the Association's 'net worth'.

In nearly all cases this fund has been built up out of past surpluses on Income and Expenditure Account which takes the place of the more usual revenue accounts presented by business undertakings. Another possible source is legacies and similar benefactions.

As on the termination of the association any surplus is presumably divisible between the Members for the time being, a substantial accumulated fund is at once the reason and justification for an entrance fee for new Members. If this particular association has 4,000 Members, each new Member joining acquires an interest (taking the assets at book value) worth about £10. This fact is often overlooked when the

Committee of the club decides to reduce or waive the entrance fee for a period, to attract new Members.

Apart from the legal and technical difficulties which arise in taking security from an unincorporated association, its balance sheet is, in essence, exactly similar in character to that of a company and requires from a lending banker much the same assessment.

BALANCE SHEET E

PLANTATION INDUSTRY

BALANCE SHEET RATIOS			
Net Worth	68%	Fixed Assets	54.6%
Current Liabilities	32%	Current Assets	45.4%
	<u>100%</u>		<u>100.0%</u>
Current Ratio 1.4			
Liquid Ratio 1.1			

The most striking thing about these accounts is the lay-out. The balance sheet conforms closely to the analysis form set out in Example II on page 25. The revenue account is in the narrative form so common in the United States, which traces step by step the income and expenditure from the year's sales to final unappropriated balance. The reader will be able to form his own view: but there is much to be said for a straightforward and simple statement of total earnings and of their disposal in this way.

As a result of the fact that sales are largely for cash against documents, cash is large (with a high liquid ratio) and debtors negligible. In such circumstances a current ratio of around 1½ is neither unusual nor disquieting.

Nothing has been written off the rubber estates for depreciation since June, 1948. Assuming that the buildings are well maintained¹ and careful cultivation and replanting¹ are carried out, there is no objection to this: but the accounts are not very informative on this point and enquiry might be made. An interesting feature in plantation accounts is the basis of valuation for stock at the end of the year: this is taken at prices subsequently realized, the most accurate basis for ascertaining true profit. As this cuts out one of the many estimations which have already been discussed, it is to be recommended for wider application where practicable.

¹ See note 3 to balance sheet, and profit and loss account.

Historically it has probably arisen from the prevalent practice of the rubber industry to sell part of its crop forward. Where this has been done valuation of stock on hand at market prices current at the balance sheet date would obviously be wrong.

It will be noted that provision for 1953-54 U.K. Income Tax—£11,950—is included in the net worth as a reserve: not amongst the provisions as a current liability. This tax (based on the accounting profits of the year to 30th June 1952) is not payable until January 1954: that is, eighteen months ahead: it would therefore not be regarded as a current liability in normal accounting practice. But there is a much more solid reason: unless trading continues beyond 5th April 1953 no liability to tax for 1953-54 can arise at all. This is the real basis for the Addendum to Recommendation III.

BALANCE SHEET F

EXTRACTIVE INDUSTRY

BALANCE SHEET RATIOS

Real Capital .	57.0%	Fixed Assets .	36.8%
Current Liabilities .	43.0%	Current Assets .	63.2%
	<u>100.0%</u>		<u>100.0%</u>

Current Ratio 1.5

Liquid Ratio Negligible

Real Capital represented by:	Net Fixed Assets*	35.5%
	Working Capital	64.5%
		<u>100.0%</u>

* But see *infra* regarding the position of stocks of stone.

This balance sheet presents some interesting features. The Investment Reserve (grouped with Capital Reserves) indicates capital profit made on investments no longer held. Share premium account is shown separately in accordance with the requirements of the 1948 Companies Act. Future taxation (not payable until January 1954) is properly shown as a reserve and not a provision.¹

Only one-third of the current assets is provided by proprietors' capital (after deducting fixed assets) and the bank overdraft has the appearance of a lock-up. The fact that the

¹ Addendum to Recommendation III.

bank is prepared to lend £52,000 on the security of certain of the company's properties, suggests that the balance sheet valuation of £80,000 is conservative. 'Ridding Values', the cost of removing the overburden and uncovering the stone ready for blasting is the quarryman's equivalent of the manufacturer's 'work-in-progress'. Road development, also included in current assets, is of a similar nature. The existence of a substantial work-in-progress item in addition to 'Riddings' suggests that the company also runs a substantial stone masonry department. It is interesting to observe that in a mining company's accounts, development expenditure is usually treated as a fixed asset and has to be incurred mainly before production commences: in a quarry company 'rid-dings' and roads proceeding step by step just in advance of the extraction of stone, are current assets.

A noteworthy feature of this balance sheet is the substantial amount written off the properties. A company established expressly to exploit a wasting asset like stone or other mineral deposits is under no legal obligation to make good such wasting assets out of profits.¹ Provided the members appreciate that their dividends contain a return of capital ingredient (albeit wholly taxed as income like normal life annuities) no one is deceived or injured if, when the deposits have been worked out, there are no assets left.

In the present instance the quarrying of stone could be subsidiary to the company's main activity of manufacturing or processing stone. In that case, the stone lying in the company's quarry properties might properly be regarded as stock in hand and fall to be revalued year by year, in the same way as industrial stocks of raw materials; such stocks of stone would then be included in the circulating assets.² The principle may, in fact, have been followed in the present case in the course of writing down the value of properties, even though, because of the difficulty of segregating the stock ingredient, they are still grouped with the fixed assets.

In lending to extractive industry the banker will always have in mind the fact that he is dealing with wasting assets, however they may be treated in the accounts.

¹ *Lee v. Neuchatel Asphalte Company*, 1889.

² *Bond v. The Barrow Haematite Steel Co.*, 1902.

BALANCE SHEET RATIOS

	%		%
Real Capital (after deducting Directors' Loans) . . .	69.7	Fixed Assets (<i>Less</i> Directors' Loans)	47.9
Current Liabilities . . .	30.3	Current Assets	52.1
	<u>100.0</u>		<u>100.0</u>

Current Ratio 1.7

Liquid Ratio Nil

Real Capital (*less* Directors' loans) provides the whole of the fixed assets and 42% of the current assets.

Net profit (before tax) on turnover	4.6%	on end-year total resources employed	6.9%
Net profit (before tax and directors' drawings) . . .	7.0%	on end-year total resources employed	10.1%

The first point to note is the heavy withdrawals by the directors in the form of loans. As the company is an exempt private company, probably an old family business (indicated by the nominal dividends and the withdrawal of most of the year's profits by way of directors' remuneration) this is not so irregular as might at first appear. The directors have evidently preferred this method of drawing out, tax-free, some of the profits ploughed back into the business in past years, and now surplus to requirements, rather than by the payment of dividends or additional remuneration which are subject to income- and sur-tax. But the day of reckoning must come. This course would obviously be improper if it jeopardized in any way the position of the creditors or materially weakened the current strength of the company. As it is, debtors exceed creditors and the current ratio is satisfactory. Nevertheless, in view of the substantial bank overdraft (unless this is quite temporary) it looks as if the blood-letting treatment may have been a little overdone.

The grouping of the assets is unusual with marketable investments and directors' loans included with the fixed assets; though, as far as the latter item is concerned, this may be a bit of North Country realism! The large investment in non-industrial properties looks a little strange but may well comprise a group of workmen's houses for the employees of the company. Two characteristic items are the vital water

rights and secret processes purchased, which may well be undervalued in the balance sheet.

A noteworthy feature at the balance sheet date is the high tie-up in work-in-progress, equal to $9\frac{1}{2}$ weeks' out-turn. This is a reflection of the lengthy processes involved, shearing and, particularly, drying and shrinking. Subject to the comments made in Chapter IX, the term of credit given— $8\frac{1}{2}$ weeks—also seems high.

The general impression is one of soundness and strength, equal to any likely recession in trade; but the banker would like to know the value (if any) of the directors' loans, as a cushion for bad times.

BALANCE SHEET H

MINING FINANCE COMPANY

BALANCE SHEET RATIOS

	%		%
Real Capital	77.6	Investments	68.4
Long-term Loan . . .	13.0	Fixed Assets	14.4
Current Liabilities . .	9.4	Current Assets	
		Liquid	15.0
		Other	2.2
			17.2
	<u>100.0</u>		<u>100.0</u>

Current Ratio 1.8

Liquid Ratio 1.6

Real capital plus long-term loans cover all the fixed assets and 45.3% of the current assets

Net profit (before taxation) 90.4% of total revenue
 9.4% on total assets held at the balance sheet date.

From the information given in the accounts alone the exact correct division of the assets between fixed and current is not entirely free from doubt. It is assumed however that Recommendation III (3)¹ has been followed, in which case of the total receipts (*less* administration expenses, which should not be large), £1,598,000, no less than £1,245,000 is gross investment income. It is reasonable to infer therefore that the company's main activity is that of an investment holding² company: and a successful one, since the gross dividends on the investments (taking the average of values at the beginning

¹ That dividends received should be shown gross.

² There may, of course, be substantial dealings in shares, the extent of which cannot be gauged.

and end of the year, and ignoring the investments in subsidiaries from which the returns included in the company's accounts are small at £6,399) come out at 11.6%. But out of this satisfactory figure some allowance must be made for the amortization of capital invested in mines exploiting wasting assets. The investments may therefore quite properly be regarded as fixed assets.

In spite of an encroachment of £423,000 on the investment reserve and the allocation of £500,000 from the year's profits to make good the fall in the value of the investments, real capital has fallen only by £397,000, and still shows a valuation per share of over £3, assuming that the assets will realize no more than their written-down book values.

The accounts show the following interesting features:

- (i) Quite exceptional liquidity which, unless quite temporary, suggests that the new loan capital has not yet been fully employed.
- (ii) As the investments in subsidiary companies represent less than 5% of the total investments, the directors have decided that the presentation of consolidated accounts would serve no useful purpose.
- (iii) Under exemption from the Board of Trade the market value of quoted investments is not shown.
- (iv) The amount of unclaimed dividends is high. As a claim for such dividends is not Statute barred for twenty years unless the company's Articles otherwise provide, this liability may have accumulated over quite a long period, particularly during the war.¹
- (v) Again we have the admirably clear narrative form of presenting the profit and loss account, already noted in connection with Balance Sheet E.

The general impression given by these accounts is one of great strength and enlightened management.

¹ The company has substantial numbers of share warrants to Bearer outstanding, on which dividends are paid by coupon.

BALANCE SHEET I

HIRE PURCHASE FINANCE

BALANCE SHEET RATIOS

	%		%
Real Capital	25.3	Fixed Assets	1.0
Loan Capital	8.9	Current Assets	99.0
Current Liabilities			
Banks	44.1		
Deposits	10.5		
Other	11.2		
	<hr/> 65.8		
	<hr/> 100.0		<hr/> 100.0
	<hr/> <hr/>		<hr/> <hr/>

Current Ratio 1.4

Liquid Ratio negligible

Net profit before taxation represents a return of 3.48% on the total assets employed and 14.9% on real capital, at the balance sheet date.

In this type of business the regular monthly inflow of cash can usually be calculated so closely that only a minimum cushion of cash in hand is necessary. The low current ratio and the negligible liquid ratio need not therefore cause anxiety. In case of need, cash can be quickly accumulated by declining new contracts and letting the existing ones run off.

Advances under hire purchase contracts necessarily appear in full as assets under 'amounts due or to fall due'. As however such amounts include an ingredient of interest which is not yet due and which cannot yet be credited to revenue account, such future interest is credited *per contra* to 'deferred charges' and included amongst the current liabilities.

A notable feature is the amount of creditor capital employed. Bank and other advances (secured by charges over hire purchase contracts) and deposits are just over twice the 'net worth'. $3\frac{1}{2}$ times is considered to be the safe limit for such short-term finance in this type of business, and if it were not for official restrictions on bank lending to Hire Purchase companies, much higher bank borrowing might be seen. The bank advances have all the appearance of permanent lock-ups: but the nature of the security, short-term hire purchase contracts with probably a maximum term of 24 months, clothes these advances with the necessary liquidity should the need arise.

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The banker usually limits his advances to (say) 75% of the amounts due under approved contracts deposited with him under a general charge, and will exclude contracts with more than 18 or 24 months to run, or in respect of which instalments are more than (say) three months in arrears. The actual terms will depend very much on the nature of the business handled: frequent returns covering the material points are a *sine qua non*. The fact that at the balance sheet date (as disclosed in the Chairman's statement) arrears of rentals represented only 1.2% of amounts outstanding indicates sound management and a careful selection of risks, made easier in this case because there is more business on offer than can be financed.

BALANCE SHEET J

CHAIN STORE COMPANY

BALANCE SHEET RATIOS

	%		%
Real Capital*	66.5	Fixed Assets*	28.3
Long Term Loans	1.1	Current Assets	71.7
Current Liabilities	32.4		
	<u>100.0</u>		<u>100.0</u>

Current Ratio 2.5

Liquid Ratio 1.8

* Obsolescence provision £1,600,000 deducted from both these figures.

Net profit (before taxation) shows a return of no less than 41% on the book value of the assets at the balance sheet date. In the absence of figures of total sales, which, with a few notable exceptions, British undertakings are still reluctant to publish, (unlike their counterparts in the U.S.A.) no net profit/turn-over relationship can be computed.

The lay-out of the accounts is workmanlike and efficient, though one notable deviation from standard practice is the deduction of current liabilities (but not provisions) from current assets to throw out one figure for net current assets: both current liabilities and assets appear inset on the asset side of the balance sheet. Unusual, too, is the showing of marketable investments separate from the current assets.

The provision for obsolescence and depreciation of buildings could properly have been shown as a deduction from the asset figure if in fact it represents an assessment of loss in value: this course has been followed in computing the balance sheet ratios set out above.

The most striking features of the accounts (due to the fact that all sales are for cash) are of course the complete absence of trade debtors and, as a corollary, the large cash balances. The liquid ratio is phenomenally high. After payment of the income tax, £5,550,000 due on the day following the balance sheet date, this ratio will be even higher at 2.2. In view of the balance sheet date it may be suspected that following heavy Christmas sales the cash is abnormally high and stock abnormally low. This would go some way to explaining the surprising conclusion that a trading profit of £16,657,000 has apparently been earned on a stock of £11,000,000. Assuming a trading profit of only 10% on turnover, sales of the order of £166,000,000 must be envisaged. This gives a turnover of the stock every $3\frac{1}{2}$ weeks. If higher profits are earned, the rate of turnover would be even quicker. This looks therefore like one of those extreme cases where the position shown by the balance sheet differs markedly from the normal position throughout the year, referred to in Chapter IX.

The position is obviously one of immense strength. Against this background the provision of £91,000 for the depreciation of investments which from their grouping apart from the current assets are unlikely to be sold, and which in his report the Chairman states to be mainly short-dated, looks almost ultra-conservative. In similar circumstances some of the banks have decided that provision to cover temporary market fluctuations is unnecessary on the ground that the investments in question will be held to maturity and no loss will be made.

If sales are at least £160,000,000 (and probably much higher) purchases must be in excess of £125,000,000, so that if the balance sheet figure for creditors, £6,793,000, is normal, payment for all purchases within 3 weeks is indicated. Even if this figure is wrong by plus or minus 25%, exceptionally prompt payment to suppliers is still shown.

*

*

*

The specimen accounts examined here have disclosed the widest variations in the balance of the key ingredients in the balance sheet:

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Proprietors' Capital	varying from	77.6%	to	25.3%	of total funds
Current Liabilities	"	"	71.7%	to	9.4% " " "
Fixed Assets	"	"	82.8%	to	1.0% " " "
Current Assets	"	"	99.0%	to	17.2% " " "
Current Ratio	"	"	2.5%	to	.62%
Liquid Ratio	"	"	1.8%	to	Nil

The same basic ingredients have been combined in differing proportions to produce dishes of infinite variety. A study of these differences and a search for the underlying reasons will bring home the lesson that no accounts can be read intelligently without a working knowledge of the nature of the particular business.

Lack of space has excluded the accounts of many types of undertaking—shipping, insurance, aircraft operation, contracting, building finance (building societies), catering and hotels and a host of others, which all have features of special interest. The earnest student will take the opportunity of studying them all, item by item, as they come his way.

CHAPTER XII

BREAKING UP A BALANCE SHEET

Purpose of Break-up – Forced Sale Values – The Traditional Method – The Assumptions on which it is Based – Analysis of these Assumptions as they effect Land and Buildings – Plant and Machinery – The Current Position – Conclusion.

EXCEPTION has been taken in certain quarters to the author's considered view that:

- (1) a 'gone-concern' approach to a borrower's balance sheet is outmoded;
- (2) no juggling with balance sheet figures can effectively answer the banker's enquiry, 'How much in the £ will the Company be able to pay on liquidation?'

The objections to this view are so strongly entrenched that they deserve a reasoned reply.

Clearly the purpose of computing a break-up value from a balance sheet is to ascertain an insurance or salvage figure which in any reasonably foreseeable circumstances should be realized. It is thus analogous to the 'forced sale' value of a factory – to take a very simple example – as security for a bank loan.

It is a matter of experience that the difference between the forced sale and present willing-buyer-and-seller values can be substantial. A case comes to mind of a factory valued for a purchaser at £250,000 and as security for a bank at £75,000. The two valuers concerned are household names in the City of London, and each was right. They produced different figures because they were answering different questions. The customer was both astonished and aggrieved, but saw the point when he was told, 'No doubt the property would realize what you gave for it now, but the bank is not considering a sale now, it is concerned with realizable value for some years ahead.' For a lending bank a forced sale value is affected by the following general factors:

- (1) The forced sale will take place (if at all) at an unspecified future time, when the customer's position will have worsened so much that there is no alternative.
- (2) By that time the property will have been recently occupied by a 'gone concern', not a good selling point.
- (3) The price obtainable is likely to be affected by the general knowledge that a receiver has been put in by the bank; this is not a good selling point either.
- (4) The chances are that the changed business climate which has brought the customer down has also brought other similar properties into the market – perhaps in the same area – and will at the same time discourage purchase by another enterprise except at a bargain price.

There are also individual considerations applicable to a particular factory:

- (5) Is it specialized in lay-out and construction, or is it widely adaptable to many types of industry? For instance, are the upper floors capable of carrying heavy machinery? Are heavy-duty elevators installed?
- (6) Is it well served by railway, river or canal: or do the available transport facilities confine its use to light industry?
- (7) Do planning restrictions limit its possible user?
- (8) What are the available supplies of labour – skilled and unskilled, male and female? In times of housing shortages which exacerbate the natural immobility of labour, this is vital. In practice the range of the market will be severely limited if the available labour force is not flexible in character.

All these factors bear on the adaptability of a particular property. The less the adaptability the narrower the market and the lower the price obtainable. Is it any wonder there-

fore that a skilled appraiser takes endless trouble in inspection and enquiry, and in weighing the various considerations, both favourable and adverse, before he is prepared to say to the bank: 'Well, you ought to get £75,000, come what may'?

Yet such a forced sale valuation, though clearly involving a large element of approximation and personal opinion, is in principle simple and straightforward, compared with fixing an even approximate value for a whole undertaking.

In the light of these comments let us now look over the shoulder of our traditional banker solemnly working (perhaps at Head Office remote from the company's factory which he has never seen) through the balance sheet of Manufacturers Ltd. for 31st March, 1947.¹

He thinks aloud. 'Factory . . . um, um . . . 50%: Plant and Machinery . . . wears out and gets out of date . . . can't say more than 25%: Fixtures and Fittings, half – well say 40%: Raw Materials . . . very little here . . . 20% is enough . . .' He stops and frowns, 'Work-in-Progress . . . ah! that's difficult that is . . . perhaps one-third.' Then he glances at the remaining items, and free-wheels happily to the end. 'Stock . . . 50% here: Debtors and Bills, I always give them two-thirds: and Cash . . . well, of course, 100%.' He does a rapid cast and deftly discloses the result shown on the next page to his admiring assistant.

'There you are, my boy, let hard times slaughter this balance sheet. . . . We've cut the assets to below half . . . and they'll still pay 20/- in the £. A very sound proposition.'

His junior stifles an impulse to enquire 'Half of what?' and asks instead 'What does this really mean, Sir; that to break up any balance sheet in this way gives a guaranteed margin of safety . . . ?'

'Well, not quite guaranteed,' interposes the banker, 'but near enough for practical purposes.' ' . . . for a period, say five years?' continues the assistant. The banker nods, 'Yes, every bit of that,' he declares with conviction.

The assistant carefully takes a copy of the workings, makes a red ink note – 'valid for 5 years', and learns the percentages off by heart (as his mentor probably did a generation before).

¹ See page 252, post.

Example XVIII

BREAK-UP OF MARCH 1947 BALANCE SHEET

<i>Fixed Assets</i>	<i>Balance Sheet Figure £</i>	<i>Percentage applied %</i>	<i>Minimum Realizable Value £</i>
Factory	98,600	50	49,300
Plant and Machinery	55,000	25	13,750
Fixtures	5,000	40	2,000
	<hr/> 158,600		<hr/> 65,050
<i>Current Assets</i>			
Raw Materials	10,000	20	2,000
Work-in-Progress	15,000	33.½	5,000
Stock	40,000	50	20,000
Debtors and Bills	17,000	66.¾	11,330
Cash	10,000	100	10,000
	<hr/> £250,600		<hr/>
Break-up Value of Assets			113,380
LESS Debenture	70,000		
Taxation (Preferential)	10,000		80,000
	<hr/>		<hr/>
Available to meet Ordinary Creditors	32,000		<hr/> £33,380
Minimum dividend foreshadowed, £1 os. 10d. in the £.			

Twelve months later the assistant who has begun to develop doubts eagerly seizes the first opportunity of testing the technique of break-up on the 1948 Balance Sheet (see Appendix II).

He has been arguing thus: 'If it is true that the minimum dividend in the £ ascertained by breaking up any balance sheet can be relied on for at least five years, then it must be true that the break-up of the next four annual balance sheets cannot show a lower dividend: for the fifth year after the first balance sheet is the first year after the fifth year's balance sheet and is common to the five-year period of them all. If it is true for any five years it is true for the last four and for the last four plus one – another period of five years: in short if it is true at all it is true for ever, and once a minimum dividend is established by correctly breaking-up any one balance sheet it holds good for all time, whatever changes of fortune may affect the business or the trading community in which it works'; which, as Euclid delighted to say, is absurd.

Example XIX

BREAK-UP OF MARCH 1948 BALANCE SHEET

	<i>Balance Sheet Figure £</i>	<i>Percentage applied %</i>	<i>Minimum Realizable Value £</i>
<i>Fixed Assets</i>			
Freehold Factory . .	98,600	50	49,300
Plant and Machinery . .	55,000	25	13,750
Fixtures and Fittings . .	5,000	40	2,000
	<hr/> 158,600		<hr/> 65,050
<i>Current Assets</i>			
Raw Materials . .	10,000	20	2,000
Work-in-Progress . .	50,000	33½	16,660
Stock of finished goods . .	50,000	50	25,000
Debtors . .	17,000	66⅔	11,330
	<hr/> £285,600		<hr/>
Minimum realizable value	<hr/> <hr/>	Minimum rea- lizable value	£120,040
<i>LESS</i>			
Debentures	70,000		
Taxation (Preferential?)	14,000		
	<hr/>		<hr/> 84,000
			<hr/> 36,040
Available to meet Creditors	£58,000		<hr/> <hr/>
Minimum Dividend foreshadowed 12/5d. in £			

It will be noted that the 25% is applied automatically to the book value of the plant and machinery, ignoring the fact that nothing whatever has been written off for wear and tear during the year.

So the 1947 balance sheet says that up to 1952 a dividend of not less than 20/- in the £ is assured to the unsecured creditors, and the 1948 balance sheet says with equal assurance that up to 1952 plus one year, the minimum which is assured to the unsecured creditors is 12/5d. in the £. Can it be that a process which gives such divergent results from two consecutive balance sheets is unsound? It may be argued, of course, that the example is specially selected to prove the case: that as set out in Chapter XV, 1948 was a year of setback. Well, of course: but was not the whole purpose of the break-up of the 1947 balance sheet to arrive at a salvage figure which would hold good for a period even after the most

serious likely set-back? As early as only one year later, when the set-back has scarcely begun to develop, second thoughts are clearly imperative.

It may be helpful to examine the various assumptions which are implicit in the method both as to the future realizable value of the assets (both fixed and current) and the liabilities which the realization will have to cover. These assumptions are as follows:

- (1) That it is possible to take a view of the future forced sale value of the **FIXED ASSETS** from no other information than their book values and description in the balance sheet.
- (2) That over a period of years the **CURRENT ASSETS** will remain fairly constant not only in book total but in the relative proportions of the different items; this last is essential since different realization percentages are understandably applied according to the nature of the current asset.
- (3) That the **TOTAL CREDITORS** to be met will not materially increase or contain a higher preferential or secured ingredient than at the date of the balance sheet examined.

FIXED ASSETS

(1) LAND AND BUILDINGS

What do the figures appearing in the balance sheet represent? They represent historic cost based on the accountants' only possible assumption that all pounds whether expended in 1900, or in 1913, or in 1950 are of equal value. Such cost figures will have been reduced by amounts written off. The amounts realized on sale will also have been deducted, but the amounts of such deductions will not necessarily be shown in later balance sheets, nor, unless the sales took place in the year of account, how long ago they occurred. There will be nothing to indicate whether any item was sold at a price greatly above or greatly below its individual book value. The effect is that any profit made on such sale will have written down the book value of what remains. Conversely, any loss

sustained will have written up the book value of the remainder.

Suppose, for example, the item: Land and Factory Buildings at cost – £500,000 – in fact represents two identical factories A and B of equal historic cost and value, and suppose A is sold for £400,000.

The item will then appear in the balance sheet:

	£	£
Land and Factory Buildings at Cost	500,000	
Less Sales	400,000	
	<hr/>	100,000

The book value of B thus appears in the balance sheet at £100,000 even though, by the evidence of the sale of A at £400,000, it was, at the time of the sale, worth four times as much. The book value of B has been written down by the amount of the profit – £150,000, realized on the sale of A – and this fact will be completely hidden.

If, however, A is sold instead for only £100,000, the balance sheet will show:

	£	£
Land and Factory Buildings at Cost	500,000	
Less Sales	100,000	
	<hr/>	400,000

with B now carrying a book value of £400,000, though judging from the price obtained for A, it is probably only worth a quarter of that sum. In other words the book value of B has been written up by normal legitimate accounting procedure to make good – in the accounting sense – the book loss arising from the sale of A.

Alternatively, the loss or profit of £150,000 may have been debited or credited to Capital Reserve in which case Factory B will be represented by the balance sheet item:

	£	£
Land and Factory Buildings at Cost	500,000	
Less Sales	250,000	
	<hr/>	250,000

leaving B in the books at the historic cost, which equally with the £100,000 and the £400,000 probably has no relation whatever to its saleable value at the balance sheet date.

When some years afterwards the banker conducts his break-up operation he may therefore find his same Factory B represented in the balance sheet by £100,000, £250,000 or £400,000: and if the figure happens to be the £250,000 any connection between this and the Capital Reserve balance on the other side of the balance sheet will have been lost in the mists of accounting history.

Moreover, moving from this particular example, at no time will there be any indication in the balance sheet to show how much of the adjusted historical cost is attributable to factory buildings and how much to undeveloped land. This is a vitally important matter in the light of the Town & Country Planning Act, 1947. Well maintained buildings may have increased in value: in many cases land has fallen substantially. Whatever else the balance sheet figure represents therefore it certainly cannot pretend to represent the value¹ of the asset even at the balance sheet date. How can it then be a logical starting point for estimating the forced sale value of the underlying assets at some unknown future time? Surely the only admissible method is direct appraisalment after inspection and enquiry, taking into account all the relevant factors already discussed. The balance sheet figure would not be even considered by any expert valuer. Because professional valuation is expensive and to be avoided unless indispensable, there is no excuse for the employment of a cheap, misleading and unsound technique instead.

Even direct appraisalment may be misleading in extreme cases. An instance comes to mind where a factory professionally valued in September at £47,000 could be sold nine months later for no more than £3,000. The valuer had given insufficient weight to the specialized lay-out of the building, its suitability for one light industry only, and was perhaps unaware of the fact that it had been worked at a loss, by expensive imported labour, one of the contributory factors to the failure of the business.

In the absence of adequate local labour no buyer could be found for the building as a factory, and it was finally sold at a knock-down price for use as a warehouse. All the relevant

¹ The different connotations of the word 'value' in this connection have been discussed in Chapter III.

factors might have been discovered by a careful valuer: they could not possibly have been inferred by the banker from the balance sheet entry showing a book value of £42,000.

(2) PLANT AND MACHINERY

The estimation of the value, present or future, of other fixed assets from a balance sheet figure must clearly be affected by all the considerations which apply to factory and other properties. But the attempt is infinitely more complex and unsatisfactory in the case of plant and machinery. Among the many other relevant factors which the banker cannot know except after the closest inspection and enquiry are:

- (a) How much of the plant is fixed and immovable (e.g. furnaces, tanks, stills, driers and the like) and therefore virtually unsaleable. Moreover, such plant will often 'run with the land' and be caught up by mortgages or mortgage debentures.
- (b) How much of the machinery (e.g. drills, lathes, boring machines, presses, etc.) is of general utility and therefore reasonably saleable, and how much is specialized and useless except for the production of that particular factory or industry. Specialized machinery may be unrealizable if the industry concerned is in the doldrums.
- (c) The proportion of slow-moving, long-lasting machinery to fast moving machines with a high rate of wear and a short life.
- (d) The extent to which both plant and machinery are modern, obsolescent or out of date. New inventions may reduce much of the even new machinery to little more than scrap value: a marked shift in the direction of customer demand may have the same effect.
- (e) The adequacy of the past depreciation provisions which obviously effect the starting figure for any estimate of break-up value.

- (f) The extent to which machinery is subject to hire purchase contracts and pledged as security. This will certainly be a very real factor when an attempt is made to assess what will be available from the liquidation for (1) a debenture holder, (2) an unsecured creditor.

If break-up procedures applied to balance sheet figures for land and buildings are unsound, how much more must this apply in the case of plant and machinery?

CURRENT ASSETS AND LIABILITIES

The reader will have realized by now that in the moving kaleidoscope of business the amount and make-up of the current assets are changing from day to day, almost from hour to hour. When the banker is setting out to break-up a balance sheet his underlying purpose is to foresee the shape of things to come when things have gone wrong and his customer is in serious difficulty. What possible relation can there be between the current position disclosed in last year's balance sheet and that which will obtain when the crisis breaks? Some or all of the following changes will certainly have taken place:

- (a) As a result of trading losses working capital will have been depleted either by the increase in current liabilities or the shrinkage in current assets, or both.
- (b) In the probable increased current liabilities the preferential element¹ may have swollen alarmingly to the detriment even of a debenture holder; secured hire purchase liabilities of substantial amount may have emerged.
- (c) On the other side a substantial shift may be expected in the make-up of the diminished current assets. Raw materials and work-in-progress may have shrunk, or, according to the nature of the crisis, have developed into an intractable frostbite of

¹ Represented by unpaid Income and Profit Tax, Purchase Tax, P.A.Y.E., Rates, Salaries and even wages.

frozen and unrealizable assets. Stock, now clearly unsaleable, may have risen steeply or practically disappeared following forced sales. Debtors (valued by our banker at $66\frac{2}{3}\%$) will probably have dwindled with falling sales. Cash (brought into the computation at 100%) will almost certainly have disappeared altogether along with all marketable investments.

It might be possible to take a backward view of what the current assets would have realized *at the balance sheet date*: the liabilities at that date would also be fairly stated. But nothing is more sure than that both current liabilities and assets will have suffered such a sea-change during the period leading to final shipwreck, as to make nonsense of any forecast based on past balance sheet figures. The book values of fixed assets are useless as a starting point for any estimate of realizable value whether at the already past balance sheet date or for the future.

The matter cannot be summed up better than in the *ex cathedra* views contained in the report of the Cohen Committee:¹ 'As stated in the evidence of the Institute of Chartered Accountants . . . the function of a balance sheet may be stated briefly to be an endeavour to show the share capital, reserves (distinguishing those which are available for distribution as dividends from those not regarded as so available) and liabilities of a company at the date as at which it is prepared, and the manner in which the total moneys representing them are distributed over the several types of assets. A balance sheet is thus an historical document and does not as a general rule purport to show the net worth of an undertaking at any particular date or the present realizable value of such items as goodwill, land and buildings, plant and machinery, nor, except in cases where realizable value is less than cost, does it normally show the realizable value of stock in trade. Moreover, if a balance sheet were to attempt to show the net worth of the undertaking, the fixed assets would require to be re-valued at frequent intervals and the information thus given would be deceptive since² *the value of*

¹ Cmd. 6659, June 1945, para. 98. ² The italics are the present writer's.

such assets while the company is a going concern will in most cases have no relation to their value if the undertaking fails.'

The assumptions¹ which alone could give a semblance of validity to the accepted break-up procedure have failed to stand up to examination.

If the question is asked, 'How then can we ascertain from its balance sheet how much can be lent to an undertaking with safety?' the answer must be honest and direct, 'You can't.' For far too long we have accepted the mumbo-jumbo of a traditional method which is deceptively simple and dangerously misleading.

¹ page 168 *ante*.

CHAPTER XIII

OVER-TRADING

Nature – General Causes: Inflation: Taxation – Internal Causes: Mistakes of Financial Policy – Results – Signs in Accounts – The Cure.

ENTERPRISING lending is the real test of a banker's judgement and skill. The need of many would-be borrowers for increased resources is clear enough, but in a number of cases the advance would obviously entail so great an element of lock-up, that the banker would prefer not to become involved; and in many cases where an advance would pass normal banking tests, the Government control of borrowing¹ stands in the way. The so-called MacMillan Gap, which it was recognized could not properly be filled by the banks, has not been fully closed by the special institutions set up after the MacMillan Report.² Eligible new savings in private hands and in the coffers of business enterprises have withered under the blast of continued heavy taxation. A significant part of the industry and commerce of this country has a struggle even to maintain, much less increase, turnover, handicapped as it is by obsolescent equipment and shortage of working capital: in short, it is over-trading.

The nature of over-trading is simply stated. It is a matter of trying to maintain a scale of operations with insufficient cash resources. An analogy suggested by our examination of cash circulation in Chapter VII, is that of an anaemic man striving to do work too heavy for him and in danger of final and fatal exhaustion. In accountancy circles over-trading is often graphically described as 'over-blowing the balloon'. It is an apt metaphor. Over-trading involves impressive size; an increasingly thin margin of safety; a sense of strain; and the danger of sudden collapse. Another analogy, equally helpful, is suggested by the proverb 'If too many irons are put into

¹ Borrowing (Control and Guarantees) Act, 1946: Control of Borrowing Order, 1947.

² Finance Corporation for Industry and the Industrial and Commercial Finance Corporation Limited.

the fire, none will come out hot.' If the process is carried to the limit the fire may be put out altogether.

To appreciate the danger to a banker of over-trading by a borrowing customer and the importance of the banker's not becoming too far involved, he must have an understanding of:

- (a) its causes,
- (b) its effects,
- (c) the warning signs which can be recognized in his customer's accounts, and in the bank account, and
- (d) the steps which can be taken to improve the position.

The causes of over-trading fall into two classes: general causes which affect all kinds of businesses and internal causes arising from the course of an individual business and from the temperament and financial policy of the proprietors themselves.

GENERAL CAUSES

(1) INFLATION AND RISING PRICES

One of the root causes of over-trading is inflation and the consequent general rise in prices and wages. To conduct the same physical level of business as before the war, a manufacturer is now faced with a heavier tie-up of capital in fixed assets and in every one of the circulating assets. The problem of replacing or renewing fixed assets has probably not yet¹ reached its most acute stage, first of all because actual shortages have made necessary replacements often physically impossible, and secondly because the necessary finance has not always been available and it has been possible for a time to continue production with obsolescent plant. But replacements cannot be deferred indefinitely. In addition, the weight of increased circulating assets in terms of money presses upon manufacturer and merchant alike. For the same quantities of stock and given the same terms of credit allowed, the tie-up should have increased exactly in step with rising prices. In many undertakings there is the additional weight of purchase tax locked up in the stock-rooms or on the shelves.

¹ January 1954.

'Effects of Inflation. What happened after the first World War was that the rise in prices enabled industrialists and traders to make what were considered to be abnormal profits, which they ploughed back into their business . . . at that time the rate of income tax was only half of what it is today and the profits tax was unknown. . . . The making of large paper profits, which is the natural concomitant of inflation, enabled industry to maintain its real capital intact; the restriction¹ of money profit at a time of rising prices is denuding industry not of real profits but of real capital.

'Thus it is that concerns which on paper have been reasonably prosperous are selling their Government securities, borrowing from banks, or raising fresh capital – not to expand their business, as is often imagined (and said) – but in an effort to maintain the old level of production at higher prices. . . . How terribly illiquid industry is becoming will not emerge all at once; it will gradually become apparent as more and more concerns run into difficulty in finding resources to replace their fixed assets out of reserves which are inadequate,² or which have already been used to finance the rise in stock prices.'³

(2) INCREASED STOCKS

Unfortunately, however, it is no longer possible in many businesses to maintain the same levels of production or sales as before the war without carrying much greater *quantities* of raw materials or stock. The first requisite in any business is to hold, or be able to obtain at short notice, adequate supplies for all needs. When goods are in plentiful supply a much smaller stock in hand is sufficient; when supplies are short and irregular, larger physical stocks are indispensable. The tendency has therefore been to buy stocks in any quantity, to the limit of financial capacity, as and when they come on offer. And that is not all. For such a policy, enforced by circumstances, involves not only swollen stocks but *unbalanced*

¹ By taxation and in some instances by controls as well.

² Because of depreciation allowances based on cost values far below present replacement values, and the excessive taxation suffered in consequence.

³ 'Taxation and the Supply of Capital for Industry', by S. P. Chambers, *Lloyds Bank Review*, January 1949.

stocks. Many a trader has heavy stocks of certain lines which he cannot sell simply because other materials, without which they cannot be used, are in short supply. For instance, at one time many builders' merchants held excessive stocks of hand-basins and sanitary ware which were not only excessive in themselves but were partially frozen by a shortage of piping.

For similar reasons amounts locked up in work-in-progress, because of bottle-necks in one or more essential materials, may be far greater today than is explained by higher prices alone. A large contractor recently told his banker of a local authority housing scheme in which he was sub-contractor for all the plumbing. He had had all his material on the site for fifteen months to the value of many thousands of pounds, and all paid for. Six months after the contract should have been completed he had only been able to start work in one-fifth of the houses, the progress of the remainder having been delayed by shortages of timber. Yet it would not have been safe to have delayed his purchases until he was in a position to use the materials; they might not then have been available. That is the dilemma; and it costs money.

Another factor which bears heavily on stocks, particularly those of certain retailers, is purchase tax. This is collected by the Revenue from the manufacturer or wholesaler as the case may be. The retailer pays the wholesale price plus purchase tax. The tie-up in stocks is not only increased by the rise in the price level but by super-added purchase tax which, being calculated as a percentage of wholesale cost, itself increases with every rise in prices.

(3) EXCESSIVE TAXATION

Commercial and Industrial companies are now more heavily taxed in the United Kingdom than in any other country in the world. The table opposite sets out the taxation of a company in 1952/53, when Income Tax was at 9/6d. in the £, Profits tax at $2\frac{1}{2}\%$ on retained profits and $22\frac{1}{2}\%$ on distributed profits, and Excess Profits Levy could reach a maximum of 15% on profits: and in 1937/38, the last pre-war year unaffected by the shadow of war, when the only burden was Income Tax at 5/- in the £.

The contrast is staggering. In 1952/53 a company could only plough back half its profits if it had no E.P.L. liability and paid no dividends whatever. In 1937 it could do so and still pay away a third of its profits in gross dividends. In 1937 a company could pay dividends equivalent, gross, to half its profits and still leave 37½% of its profits in the business as 'seed money'. Today, after satisfying the tax collector a similar quite conservative dividend would involve a disbursement of more than the profits earned.

TAXATION PAYABLE
(SHOWN AS A PERCENTAGE OF NET PROFIT)

	<i>Proportion of profits distributed in Gross dividends</i>				
	<i>Nil</i>	<i>¼</i>	<i>½</i>	<i>¾</i>	<i>1</i>
<i>1952/53</i>	%	%	%	%	%
Income Tax	47.5	47.5	47.5	47.5	47.5
Profits Tax	2.5	7.5	9.2	12.5	15.8
MINIMUM TAXATION	50.0	55.0	56.7	60.0	63.3
Excess Profits Levy (maximum)	15.0	15.0	15.0	15.0	15.0
MAXIMUM TAXATION	65.0	70.0	71.7	75.0	78.3
Net Dividend	—	13.1	16.5	26.2	33.0
TOTAL CASH PAID OUT TO REVENUE & SHAREHOLDERS	65.0	83.1	88.2	101.2	111.3
PROFITS RETAINED	35.0	16.9	11.8	—	—
Profits Over-distributed	—	—	—	1.2	11.3
<i>1937/38</i>					
PROFITS RETAINED	75.0	56.3	50.0	37.5	25.0
Income Tax	25.0	25.0	25.0	25.0	25.0
Net Dividend	—	18.7	25.0	37.5	50.0
	100.0	100.0	100.0	100.0	100.0

This means in simple terms that it is well nigh impossible for a present-day company to give its shareholders a reasonable return on capital and at the same time to retain out of *profits after tax* sufficient capital even to maintain its position, much less to finance expansion.

The commercial and industrial greatness of this country was built up mainly on the basis of reinvested profits in a

period of over half a century up to 1913/14 during which the standard rate of tax only twice¹ exceeded 1/2d. in the £.

Since April 1915 the standard rate of Income Tax has averaged 6/5d. in the £, since April 1940 9/5d. But it is not only a question of rate. There is in addition the effect of present accounting methods which have continued to assume a stable value for money in a long period of steeply rising prices. This has been continuous for fifteen years or so.

'Since 1938 the money cost of maintaining intact a given volume of real capital including fixed assets, stock and book debts has greatly increased. Despite this balance sheets by tradition treat all £s as being of equal value, whether they are the £s of 1951, 1938 or 1900. The convention is that in calculating profits it is sufficient to set aside a sum equal to the cost of the asset whenever it was bought, despite the fact that replacement will actually cost more.'²

The economist says that before true profit can be ascertained, provision must be made for the maintenance of all assets in real terms. The accountant says that is sufficient to provide for replacement of the assets at their historic cost. Obviously as long as there are only moderate fluctuations of value either side of a comparatively stable £ the practical effect of the two views will be roughly the same. But the £ has been anything but stable and, in the computation of profits for taxation purposes, the view of the accountant holds the field. 'In so far as the published accounts of companies understate the requisite provisions for the maintenance of assets, they correspondingly overstate the real profits earned.'³ It is to such overstated profits that the present penal rates of taxation are applied, so a tax apparently levied on income becomes partially a tax on capital.

The effect of this in both the fixed and current asset fields can best be illustrated by a simple set of accounts for a ten-year period, 1939 to 1948 inclusive. The same physical stock is maintained throughout, with a gross profit of 15% on cost

¹ The exceptions, 1/4d. in the £, in 1856/7 and 1857/8 were the result of the Crimean war and the Indian Mutiny.

² 'The effects of Inflation on Industrial Capital Resources', Federation of British Industries, November 1951.

³ op. cit., page 4.

of manufacture (=13% on sales) and depreciation of plant and machinery at 10% per annum on the written down value. The company equipped itself with a new Factory and plant in 1938.

Example XX

BALANCE SHEET, 31ST DECEMBER 1938

	£	£		£	£
Capital		400,000	Freehold Factory (at cost 1938)		200,000
Reserve		100,000	Plant and Machinery (at cost 1938)		
Profit and Loss Account		46,523		200,000	
			Less written off	20,000	
				<u>180,000</u>	
		<u>546,523</u>			<u>380,000</u>
<i>Current Liabilities</i>			<i>Current Assets</i>		
Creditors	55,143		Stock	100,000	
Taxation	15,000		Debtors	76,666	
Dividend (Net)	<u>10,000</u>		Cash	<u>70,000</u>	
		80,143			246,666
		<u>£626,666</u>			<u>£626,666</u>

10-YEAR TRADING ACCOUNT – 1ST JANUARY 1939 TO
31ST DECEMBER 1948

	£	£		£
Opening Stock		100,000	Sales	8,050,000
Cost of Manufacture		7,000,000	Closing Stock	250,000
Profit:				
Attributable to trading	1,050,000			
Attributable to stock appreciation	<u>150,000</u>			
		1,200,000		
		<u>£8,300,000</u>		<u>£8,300,000</u>

- Assumptions: (1) Constant physical stock turned over four times a year.
 (2) Steady increase in average prices from 100 in 1939 to 250 in 1948.
 (3) Trading Profit 13% on Sales.

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10-YEAR PROFIT AND LOSS ACCOUNT TO 31ST DECEMBER 1948

	£		£
Overheads . . .	175,000	Trading Profit . . .	1,200,000
Wear and Tear of Plant and Machinery (10% on written down valued) . . .	117,808		
To Appropriation Account . . .	907,192		
	<u>£1,200,000</u>		<u>£1,200,000</u>

10-YEAR APPROPRIATION ACCOUNT

	£		£
5% Dividend (Net) . . .	110,000	Net Profit . . .	907,192
(Tax @ average 9/-)			
¹ Taxation @ 9/- . . .	408,236		
Balance to Balance Sheet . . .	388,956		
	<u>£907,192</u>		<u>£907,192</u>

¹ Taxation calculated for Income Tax only. The figure would have been increased by Defence Contribution, Profits Tax and possibly Excess Profits Tax.

BALANCE SHEET, 31ST DECEMBER 1948

	£	£		£	£	£
Capital	400,000		Freehold Factory (at cost)			200,000
Reserve	100,000		Plant and Machinery at cost 1938		200,000	
Profit and Loss 31.12.38	46,523		Depreciation to 31.12.38	20,000		
Per Appropriation account	388,956		to 31.12.48	117,808		
	<u>435,479</u>			<u>137,808</u>		62,192
	935,479					<u>262,192</u>
<i>Current Liabilities</i>			<i>Current Assets</i>			
Creditors	137,858		Stock	250,000		
Taxation	63,542		Debtors	185,916		
Dividend (Net)	11,000		Investments	238,414		
	<u>212,400</u>		Cash	211,357		885,687
				<u>885,687</u>		
	<u>£1,147,879</u>					<u>£1,147,879</u>

At first sight the balance sheet looks satisfactory. Working Capital has been built up from £166,000 to £673,000: Liquid Assets from £70,000 to £450,000. Net worth is 71% up at £935,000. A modest 5% dividend has been paid regularly and profits averaging nearly £40,000 per annum have been ploughed back into the business.

But the accounts drawn in the conventional way, have only allowed £117,808 of trading profits as tax-free wear and tear allowance. In fact after ten years the plant and machinery requires complete replacement at three times its original cost: the old plant has been sold at its written down book value of £62,192 and orders already placed for the new equipment. If £70,000 was the right amount of cash to be held in the business in 1939, then £175,000 is necessary now, and to finance the replacement of plant at a cost of £600,000, less £62,192, additional cash amounting to £263,000 must be raised, not to finance expansion as the greatly increased balance sheet figures might suggest, but merely to maintain the existing level of business and corpus of assets.

The resulting balance sheet is set out in Example XXI.

This is where the bank may come in with an overdraft limit of perhaps £150,000, but only as a bridging operation. It is clear that the £263,000 required is in the nature of additional permanent capital which it is not the function of a bank to provide. We have here, then, a position where profits retained in the business (£389,000) are quite inadequate to keep its assets intact.

The real causes of the company's difficulties are:

- (1) that the ten-year account profits have been subject to heavy taxation;
- (2) that by reason of rising prices and accounting conventions such profits have been overstated.

Whilst, as we have seen, profits are not necessarily realized *in cash*, the tax payable on those profits must be paid out in cash. Taxation thus hits a business where it hurts most, by depleting cash resources. This is at once a cause and a symptom of overtrading.

In the ten-year period, the tax collector has taken out of the business £408,000; in fact, probably much more; for Excess Profits Tax, National Defence contribution, Profits Tax and Excess Profits Levy have all been ignored. If in computing the taxable profit full allowance had been made for the maintenance of real capital assets, the accounts would have read as follows: the actual figures are placed alongside for comparison:

10-YEAR APPROPRIATION ACCOUNT

<i>Actual</i>		<i>Corrected</i>	<i>Actual</i>		<i>Corrected</i>
£		£	£		£
110,000	Dividend	110,000	907,192	Net Profit	357,192
408,236	Taxation	160,736			
388,956	Balance to				
	Balance Sheet	86,456			
<hr/>		<hr/>	<hr/>		<hr/>
£907,192		£357,192	£907,192		£357,192
<hr/>		<hr/>	<hr/>		<hr/>

The amount of cash extracted from the business in the form of tax on capital is therefore no less than £247,500. Had this saving on a true profit basis been available in cash or

other liquid form to finance the plant replacement programme, the final balance sheet position would have been:

Example XXIII

BALANCE SHEET, JANUARY 1949				
	£	£		£
Capital . . .	.	400,000	Freehold Factory at	
Reserve . . .	.	500,000	cost	200,000
Profit and Loss . . .	.	132,979	Plant and Machinery at	
			cost less Sales and	
			amounts written off	600,000
				<hr/>
				800,000
		<hr/>		
		1,032,979		
			<i>Current Assets</i>	
Creditors . . .	137,858		Stock £250,000	
Taxation ¹ . . .	24,800		Debtors £185,916	
Dividend			<hr/>	
(Net) . . .	11,000			435,916
Bank Over-				
draft . . .	29,279			
	<hr/>	202,937		
		<hr/>		
		£1,235,916		<hr/>
				£1,235,916
				<hr/>

While the position is much improved, the maintenance of true assets still places a strain on the company's resources; largely because wear and tear provisions instead of being available in liquid form for their primary purpose of replacing the plant and machinery, have had to be used in part to finance stock and debtors at higher prices. A seriously illiquid position is shown.

An authority² has estimated that capital was assessed for taxation as income in the United Kingdom during the decade 1939 to 1948 as follows:

	£ million
In respect of Stock Appreciation . . .	2,000
In respect of Under-provision for Wear and Tear	1,500
	<hr/>
	£3,500
	<hr/>

¹ The provision for taxation has been proportionately reduced in step with the reduced real profits.

² K. Lacey in the *Economic Journal*, December 1951.

This represents probably £2,000,000,000 withdrawn in ten years from the cash capital resources of industry and commerce to pay taxes of all kinds and utilized by the State largely for income purposes. It should be particularly noted that inadequate depreciation allowances bear most heavily on those heavy fixed capital industries which are the backbone of our economy.

Unless this purblind finance can be stopped the running down of our economic machine is inevitable. Taxation at this level and on this ill-conceived basis is killing incentive, throttling expansion and even threatening survival. It is common knowledge that the motor car industry is a major contributor to the solution of our balance of payments problem. Under present fiscal conditions the emergence of another Nuffield organization, largely built up out of ploughed-back profits, is impossible.

In certain primitive societies where the success of next year's harvest could mean survival and its failure starvation, the seed corn was guarded as the community's most precious possession. To steal and eat it was a crime punishable by death. In these more enlightened days, with our eyes open, we are eating the seed corn of industry. What fall in the standard of living will certainly come because we sacrifice for present consumption the hundredfold increase of next year's harvest? What unknown crops of unbelievable richness – as unimagined, as in 1900 were the present motor car and electronic industries – will never even be sown?

For the banker the results of the locust-ravaged years since 1940 are clear and stark. Because of cash paid away for taxation over-trading is widespread and growing. It must never be forgotten that nearly 80% of the commerce and industry of this country is conducted by small units employing 250 or less. They are too small to make public issues of share or loan capital: private savings are no longer available in sufficient amounts: where can they turn except to the banks? If he lends, the banker may find that he has locked up permanent capital: he may also find that to protect the first advance he is forced, against his better judgement, to lend still more.

INTERNAL CAUSES

(1) DEPLETION OF WORKING CAPITAL

We have already examined the comparatively limited number of ways in which working capital can be depleted.¹ All of these will ultimately, if not immediately, involve a disbursement of actual cash. The most common errors in financial policy which can bring about cash shortage and a condition of over-trading are: (1) denuding a business of essential cash and endeavouring to maintain the business without it; and (2) attempting to expand the volume of business beyond what is justified by the resources available. The two policies often operate together.

A manufacturing company had been running successfully for many years with a turnover of £100,000, gross profit of £30,000 and a net profit of £14,000 per year. The paid-up capital was £10,000 with net worth of £20,000. The current assets had been steadily maintained at twice the amount of the current liabilities, with a very liquid position, cash in hand (some £22,000) more than covering current liabilities of £20,000. There was a change of control.

The new directors were not content to continue in the old-fashioned factory, held on a long lease at £1,000 per annum, as it restricted the prospects of expansion. They therefore decided to buy a larger factory for £55,000, borrowing £36,000 on the security of the freehold and using the whole of their available cash to complete the purchase. The change appeared to involve an increase in overheads of under a thousand a year. In fact, it was found impossible to continue the business with the reduced working capital remaining, and the projected expansion of turnover was out of the question.

Within 12 months they were borrowing £14,000 from the bank under a comprehensive debenture. At the end of the second year they were £13,000 in excess, mostly on wages account, and at one time the total bank debt was as high as £40,000. The bankers then said 'No more'. Meanwhile creditors had become critically high at nearly six months' purchases. The circulation of current assets had been so clogged that the tie-up in stocks and work-in-progress was

¹ Chapter V *ante* at page 68 *et seq.*

equivalent to nearly three months' production (as against an average of four weeks under the previous 'unenterprising' management). Bank charges alone exceeded twice the original rent: the management were distracted and at their wits' end; and instead of the former net profit of £14,000 a loss of £2,000 was made in the third year. Mainly by an ill-judged depletion of liquid capital a sound business had been brought within three years to the verge of collapse; and this in spite of the fact that by blood and sweat production had been maintained.

Sadder, wiser, and sobered by this staggering reversal of fortune, the directors decided to retrace their steps and re-liquefy their position by selling the factory to an investment trust, reserving a long lease to themselves at £3,000 a year. The penalty for their unfortunate finance will lie heavily on the company for many years. The business will be saddled with three times its former rent; a bank overdraft of £20,000; and an annual burden for bank interest and for reductions of £2,000 a year (which will have to be found out of net profits *after* taxation). On this basis the distributable profits cannot be more than half those available under the old régime. For obvious reasons certain facts and figures have been changed. But in all essentials this is a true story of over-trading brought about entirely by a voluntary over-investment in fixed assets. The same sort of effect will follow the voluntary depletion of cash resources by:

- (i) the unnecessary repayment of long-term loans,
- (ii) excessive drawings or dividend distributions,
- (iii) the investment of cash in other businesses by way of loans or share purchase.

The most difficult case of all is where the fall in working capital is the result of losses. The constant replenishment of the cash pool from the most usual source – realized profits – no longer occurs. The position may well be reached where remaining resources are insufficient to finance an increased turnover; and without increased turnover sufficient gross profit cannot be earned to cover irreducible overheads and show a profit. Faced with this situation, the lending banker's

problem is not to decide whether to step in; only when. A practical example is discussed in some detail in Chapter XV.

(2) OVER-EXPANSION

During the second World War the whole of the industry of this country was under official pressure to achieve maximum output of goods and manufactures needed for the war effort. It did not matter whether adequate capital was available or not. Very liberal assistance was given by the banks under the arrangements made with the appropriate Government Departments, who themselves assisted with factories and machinery, raw materials to be processed, and liberal progress payments. It was the heyday of the little man when, metaphorically speaking, the village blacksmith was encouraged to produce tanks. Every little back street had its workshop where essential work proceeded night and day under conditions which in normal times would reduce a factory inspector to apoplexy.

This over-emphasis on production as the supreme objective and an airy disregard of the elementary rules of sound finance still persist in some quarters and re-inforce the natural tendency of the practical man to think in terms of the tangible things he knows and understands. When he allocates his available capital he remembers the workshop, the machinery, the jigs and the tools, and tends to ignore more remote considerations like working capital to finance stocks, work-in-progress and debtors. All of us want to make money as quickly as possible and plan the most ambitious scale of production which can be financed. But there is a hard time before any *entrepreneur* who omits essential working capital from his calculations and fails to allow a wide margin for the unexpected which seems to happen so frequently.

Any banker with wide lending experience will have examined many budgets and financial forecasts in connection with advances. How often are they falsified by the event! Some of the most troublesome accounts are those where a concern has undertaken contracts beyond its power to finance. It has always been sound policy to make haste slowly: but never more essential than in times when the expansion of even the most successful business is heavily retarded by

excessive taxation. Moreover, the greatest danger of over-expansion is just at the point where the business is most successful and the manufacturer or merchant, eager to make hay while the sun shines, extends his operations over as wide a field as possible. The seeds of overtrading are sown in the good years.

He gets caught worst who deliberately ignores warnings of the coming storm and goes on over-blowing the balloon until the pressure bursts it like a bubble. All this is largely a matter of business sense and acumen; of knowing when to stop; and of having enough strength of character to act accordingly.

The following typical case (disguised like the previous one, but a true story in essentials) will illustrate the dangers of over-enthusiasm.

A small one-man company was engaged in retailing certain bread-and-butter supplies and equipment to industry. On sales of £15,000 he was making a gross profit of £4,250 (29%) and a net profit of £1,350. The following year there was a shortage of supplies which reduced his sales to £10,500 but with gross profit £3,700 (35%), some savings in overheads still made possible a net profit of £1,250. A nice little business; although at this stage an optimistic temperament, bewitched by the increased rate of gross profit, had led to considerable over-stocking, and creditors exceeded debtors by 112%. Stock at the end of the year was equivalent to six months' average sales, at £5,250. The accounts at the close of the following year showed sales back to £15,000, gross profit £4,500 (down to 30%), net profit £800 (overheads having risen by £1,250), and stock up to £6,750.

At this stage he took the balloon firmly between his lips and blew hard. He approached his bankers for as much finance as they were prepared to provide to build up stocks which would not be pressed for sale. Facilities up to £12,500 were sanctioned, partly against third party security and partly against a Debenture. A warning was given that over-trading was dangerous and that the scale of trading should be adjusted so that the account worked easily within the limit: and a reduction at the end of twelve months would be expected.

The reduction did not materialize and the accounts for the next year showed why. Sales were up to £27,500 with gross profit £7,250 (now only 26%). Creditors were double at £7,000 and stock at £13,500. Apprehension about the heavy stock had promoted an expansion of the selling organization during the year at a cost of £5,000 and net loss of £1,450 was made. Nearly double the work and worry for worse than no reward!

The bank account had lost its resilience and instead of showing a healthy swing settled down heavily round the permitted limit, with occasional excesses as the following figures show:

BANK ACCOUNT			Highest Overdraft	Lowest Overdraft (In Credit)
Year 1	.	.	£7,000	£6,750
Year 2	.	.	£12,750	£11,500
Year 3	.	.	£14,370	

Vulnerable and difficult though his position had become, the merchant remained oblivious of his danger and went to his bankers for further help. He was prepared to explain away the smallness of his net profit and pointed with pride at the greatly increased turnover. He claimed that with continued support from the bank there was scope for even further expansion. Business was good, the outlook was promising and the only difficulty was to meet the monthly accounts as they fell due – hardly surprising when the creditors' figure represented over six months' purchases. Further help was refused. Shortly afterwards this decision was more than justified when creditors started pressing, many suppliers refused further deliveries except against cash and a long fight back to a position of liquidity and safety began. This was only possible when a complete change of attitude took place: it would not have been possible at all had the crisis (which was never far away) been precipitated by any marked deterioration in general trading conditions. By no means all who so tempt fate are as fortunate.

It may be as well to insert a reference here about an insidious and dangerous form of over-trading which is sometimes practised. It is a device employed mainly by the mer-

chanting community to enable them to carry a much higher turnover than their financial resources justify by making use of 'married' documentary credits. This is not the place for a detailed explanation but, briefly, they arrange for their banker to open a documentary credit in favour of the merchants from whom they are purchasing goods and at the same time arrange for their own buyers to open covering credits in as near as possible identical terms, so that their banker can take up the documents under the first credit and recoup himself with trifling delay by presenting them and collecting cost plus profit under the covering credit. The numerous snags in this type of business are so well known that it is only necessary here to say that the security furnished by the covering credit is by no means as complete as is sometimes supposed.¹ When goods are in short supply and there is little risk of the ultimate buyer wishing to repudiate his bargain, things pass off quite smoothly. As soon, however, as a break in the seller's market occurs, there is no limit to the pretexts under which the buyer can refuse to accept the goods which are then left in the banker's hands or in those of his agent, possibly in a foreign country. There may then be no alternative but to re-ship them to a more suitable market at considerable expense or to sell them on the spot for what they will fetch.

Over-trading by means of confirmed credits is no sounder than over-trading in any other form, and the banker will be on his guard against supporting a customer with small capital too far in this direction. This is especially the case as the documents which may possibly be left in the banker's hands may themselves fall short of the desired standard and represent something less than a complete title to the goods. Even when the documentary business proceeds smoothly, technical difficulties are so frequent that often the banker has to place himself in the position of having to give indemnities in order to secure payment, for which the counter indemnity of the customer may be by no means adequate cover. Losses

¹ For a detailed examination of this and other aspects the reader is referred to the admirable series of articles on Documentary Credits in the 'Bankers Magazine' in 1952 and 1953, particularly those in the April and May 1953 numbers.

arising from such indemnities are likely to occur more frequently when trading conditions deteriorate.

THE RESULTS OF OVER-TRADING

Some of the effects of over-trading may be inferred from the two cases which have been described. They all follow, directly or indirectly, from a shortage not of assets but of cash and may be briefly summarized as follows:

(1) DIFFICULTY IN FINDING WAGES

This is the most immediate and dangerous result. If wages cannot be paid the balloon will be pricked at once and complete collapse will follow. The trader's dilemma is sometimes immediately passed on to his banker who is, quite unfairly, given the choice of finding the wages against his better judgement or putting his customer out of business. The banker's problem, as difficult as it is unpleasant, is to decide exactly when to say, 'No more!' In the case of a company the preferential position in liquidation¹ of advances for wages may enable the banker to go a little further than would be safe if the customer were a sole trader or firm.

(2) DIFFICULTY IN PAYING TAXES

P.A.Y.E. payments, representing tax deducted under code from all wages and salaries, are payable monthly. Purchase tax is payable monthly or quarterly according to arrangement. Income tax under Schedules A (property) and D (profits) is payable promptly once a year. Quite properly the Inland Revenue does not look kindly on trading with public money which is what in fact occurs when tax payments fall into arrears. And so pressure from the tax collector is often the proximate cause of bringing a company down.

(3) INCREASED COST OF PURCHASES OWING TO

- (a) Inability to accept special opportunities. In many a business opportunities arise from time to time to acquire stocks at bargain prices for cash. If cash is not available to snap up such bargain lots, substantial additional profits will be missed.

¹ Companies Act, 1948. Sec. 319 (4).

- (b) Hand-to-mouth buying. Bulk buying is cheaper than buying in small quantities. When cash is short and suppliers are becoming difficult the 'over-trader' may be forced to buy piecemeal at unfavourable prices.
- (c) *Selecting sources of supply because long credit is obtainable*, not on the prime criteria of quality, price and value.
- (d) Loss of Discounts. One of the earliest effects of over-trading is inability to pay accounts early so as to earn the discounts allowed for prompt payment.

The extent to which cash discounts benefit a buyer is often not realized. Assume that purchases are £120,000 per annum and the monthly accounts are £10,000. Six weeks credit is received. The balance sheet will thus show creditors £15,000. Supposing $2\frac{1}{2}\%$ *actual* is allowed on prompt payment within 14 days. £10,000 is borrowed at 5% per annum: Annual cost £500. Discount received during the year $2\frac{1}{2}\%$ on total purchases £120,000=£3,000: Profit £2,500: surely a very good justification for the balance sheet reading:

	£
Loan	10,000
Creditors (2 weeks' credit)	5,000

(4) REDUCTION IN EFFECTIVE SALES FIGURE BY

- (a) *Pressing stock for sale*. Where the particular form of over-trading involves the holding of excessive stocks these may have to be thrown on the market at drastically reduced prices.
- (b) *Discounts allowed*. Where the need for cash is pressing it may be necessary to tempt debtors into prompt payment by offering liberal discounts. This has the effect of reducing effective sales collections.

(5) EXPEDIENTS TO RAISE MONEY

Generally resorted to after all normal securities have already been pledged. They may be many and various but they usually have this in common; they are all expensive. The following list is by no means exhaustive:

- (a) Charges over plant and machinery, often by sale to a Hire-Purchase company and re-purchase on onerous hire-purchase terms.
- (b) Sales of book debts.
- (c) Unsecured loans at high rates justified by the real element of risk.

Such expedients usually weigh heavily upon the Profit and Loss Account, even if gross profit can be maintained.

(6) GENERAL DIFFICULTIES WITH CREDITORS

When the trader has persuaded all those of his creditors who are willing to draw bills upon him (for a consideration) and thus extend his credit, he can do no more than resist, as far as he is able, the increasing pressure which will inevitably follow. A period of trying to stop too many holes with too little material will follow, fraught with worry and anxiety. Fear of writs and worse will be his constant companion.

Moreover, a considerable interruption in normal supplies will be inevitable, with unfortunate effects on production, sales and goodwill.

(7) PRESSURE ON DEBTORS

In times of depression this will be unavoidable and may well cause resentment in the minds of good and long-standing customers who, perhaps, are also affected and have their own difficulties. Irreparable damage to goodwill may result, which will affect not only current sales but future business when better times return. If the trader can induce his debtors to accept bills, some early cash may be secured by discounting: but, as has been stressed before, this is merely borrowing from the future to meet pressing liabilities in the present and may aggravate, while it temporarily postpones, the final crisis.

(7) OBSOLETE PLANT AND MACHINERY

Shortage of cash will inevitably prevent necessary replacements of machinery. Inefficient working, with unavoidable interruptions for breakdowns and repairs, cannot fail to leave

its mark both on the volume of production and the rate of gross profit earned.

The general effects of over-trading are admirably summarized by Jones, 'When the capital of a business is disproportionate to the volume of its operations, expenditure is liable to become unduly heavy in relation to gross receipts. Goods cost more to buy when extended credit is demanded by financial exigencies; bank charges and loan interest payments expand, and embarrassment occurs when estimates are prepared for large contracts or when attractive opportunities for new business arise. The ultimate outcome of over-trading, if continued for a considerable time, may indeed be the liquidation of the company.'¹

The picture is not overdrawn. Most bankers must have been saddened by instances of sound businesses being brought to the verge of collapse and sometimes finally wrecked by over-trading. And it is saddest when the proprietors are worthy hard-working men whose only fault is that their enthusiasm is greater than their financial acumen. So often the pathetic thing is that the immediate objective, increased turnover or better premises, plant and machinery, is achieved; but because working capital has been unduly depleted, the ultimate prize, increased *net* profits, eludes the grasp. The risks, the worries and the all too frequent penalties may be incurred for nothing.

It is, of course, all a question of degree. Merely to maintain production it is often imperative that plant and machinery be renewed. Obsolete and outworn plant will usually reduce profits for at least two reasons: maintenance charges will be unduly heavy; and breakdowns will involve loss of production. To expend money upon essential replacements, and to borrow from the bank or elsewhere for the purpose, will be perfectly sound business provided cash resources are maintained at an adequate level. It is when the nice balance between fixed and working capital is unduly disturbed, that trouble almost inevitably ensues.

In protecting his bank from losses in difficult times in which over-trading will always be one of the greatest dangers, the wise credit man will look once at the accounts and twice

¹ *Guide to Company Balance Sheets and Profit and Loss Accounts*, Frank H. Jones.

at the man behind them. In his temperament or character the very first warning of this danger can often be discerned.

Nevertheless, a close watch upon the accounts and any interim figures obtained is of vital importance.

SIGNS OF OVER-TRADING IN ACCOUNTS

- (1) One of the earliest signs of over-trading in a company's figures is a tendency for the Debtors/Creditors ratio to fall progressively. This will happen when creditors increase more rapidly or fall more slowly than debtors. It may be caused by increasing difficulty in paying creditors as they become due; by creditors remaining static or increasing with growing stocks while debtors fall in step with decreasing sales; or by an undue fall in debtors as a result of increased and generally undesirable pressure.
- (2) Without corresponding increase in turnover (i.e. sales or production):
 - (a) increases in bank borrowing or loans;
 - (b) increases in creditors, usually accompanied by
 - (c) undue increases in stock of all kinds – i.e. materials, work-in-progress and finished goods.
- (3) The appearance of bills payable where this is not usual and is not accounted for by changes in the nature of the business. This may indicate extensions of time by trade creditors (at a price) or borrowing on accommodation paper.
- (4) An unexplained reduction in Bills Receivable, suggesting discounting. This will be revealed by a footnote to the balance sheet referring to the contingent liability in respect of bills discounted, but can only be inferred from periodical interim figures by an undue fall in this item.
- (5) A fall in the working capital ratio

$$\left(\text{i.e. } \frac{\text{Working Capital}}{\text{Production}} \text{ or } \frac{\text{Working Capital}}{\text{Sales}} \right),$$

indicating increased business without a corresponding increase in working capital.

- (6) (a) In the early stages the rate of gross profits may be maintained with a steady fall in net profit owing to increasing expenses.
- (b) In the later stages there is a fall in the gross profit rate as well.
- (7) Above all, a progressive fall in liquid resources, and in the ability of the undertaking to raise fresh money by borrowing, as one pledgeable asset after another goes into pawn.

THE BANK ACCOUNT

The lending banker is in the fortunate position of having a source of information not usually available to other creditors, namely the bank account itself. The alert branch manager will keep an eye well open for the following signs of over-trading:

- (a) An increasing tendency for excesses to occur, especially round the normal time for payment of the monthly accounts. There will be requests for permission to overdraw in anticipation of money which is certain to come in next week or next month: in short, to borrow from future receivables to meet current payments. This is similar to an abnormal discounting of bills receivable, and equally a portent of growing difficulties.
- (b) A less vigorous swing between the highest and lowest balances over a week, a month or other suitable period. The balance will swing narrowly either side of zero; or either side of any overdraft limit which has been arranged.
- (c) Continual pleas for assistance with wages, which at times provide for the banker a regular Friday headache.
- (d) A marked tendency for monthly accounts to be paid progressively later in the month. Often it will be

found that cheques are drawn and dated at the usual time, but that their issue is deferred until cover is available in the account.

- (e) Cheques to suppliers in even amounts suggest payments on account to keep creditors quiet. A similar but less easily detected sign is frequent and irregular payment, probably on a cash with order basis to suppliers who, in easier times, were paid once a month only. Each means that the customer is paying what he can, when he can: not when he should. An increasing number of smaller cheques is often seen, indicating that purchases are being made wherever credit and supplies can be found. When things become really difficult there may even be increasing drawings of actual cash from the bank, if that is the only kind of payment certain creditors will accept.

THE CURE

In general the cure for a state of over-trading is simple enough to prescribe: either a smaller coat, or more cloth! But when the trader has already cut out half the coat on too large a scale and has insufficient cloth to complete the garment, there will be unpleasant gaps open to the chill winds.

It is easy enough to say to a trader who has brought too much stock on credit, 'You must concentrate on reducing your stocks and curtail buying.' But the cure is easier to prescribe than to follow. Stocks must take their time to turn into cash via debtors: the pace cannot be forced except at heavy loss, which will help no one. Curtailing buying is just as difficult. There is nothing a wholesaler dislikes more than stale and dormant accounts following the cessation of orders. To pursue such a policy is to invite heavier pressure for payment and a refusal to supply except for cash the odd lines which *must* still be bought.

Where over-trading has been induced or increased by an over-investment in fixed assets, it may be feasible to re-lieve the position by finding someone else to invest the capital and by renting the fixed assets instead. This will be

possible with land and buildings which are adaptable to many types of business and well situated in regard to labour supplies and transport. It may not be so easy where the buildings are specialized, and the continuance of rent payments rests on the success of a business which is already in difficulties. That a concern takes the initiative in selling its own factory is a clear admission that all is not well. The same considerations apply to plant and machinery which can be sold to a Hire-Purchase company and re-purchased on hire-purchase terms. This is indeed giving hostages to fortune; for failure to maintain the payments will entail the loss of the plant which is the core of the business, and that may well mean the end of everything.

Whether the condition of over-trading is due to lack of wisdom or external misfortune, the only real cure is more cash. If that is not available there is no choice but to sell the business as a 'going concern', for what it will fetch, or to hang on grimly and fight and hope. It is here that the quality of the man behind the business will be really tested. Courage and resourcefulness transcend figures and balance sheets. There are cases where the banker, knowing his man, will withdraw his support at the earliest signs of serious over-trading: there are cases too where, knowing his man, the banker will be justified in backing him in spite of the figures. It is just here that the branch manager and his soundness of judgement, proved over the years and trusted by his Head Office, is of priceless value.

For customer and banker alike, however, better than any cure is prevention. The effects of serious and persistent over-trading can be so disastrous that it is better not to become involved at all.

CHAPTER XIV

HOW MUCH?

Balance Sheet Alone Will Not Give the Answer – Customer Should State Requirements – Why is Advance Necessary? – What For? – Nature of Business – Effect on Balance Sheet – Is it Enough? – Repayment – Relative Size of Banker's Stake – What Security? – Character and Capacity.

EVERY reader who has followed the argument of this book so far will have realized that it is quite useless for a customer to hand his balance sheet to his banker and ask, 'How much can you lend against that?' The customer may have a trusting belief that a balance sheet is an 'open sesame' at once to the banker's heart and treasury. The banker himself should know better; he should not give an answer without much fuller information.

Yet every credit man at Head or District Office must have had just that question asked by the branch managers with whom he works, either directly or in more general form. 'How do you decide how much can be lent against a balance sheet?' This is the old hankering after an easy formula: it dies hard. The writer will have failed if he has not made it abundantly clear that the balance sheet alone cannot furnish an answer.

Fortunately the banker from whom an advance is sought is in a strong position 'to demand the fullest information . . . and to require the production of Balance Sheets and full Profit and Loss Accounts for a series of years',¹ as well as detailed and up-to-date figures for current assets and liabilities. If full information is asked for at the outset *as a matter of course* it will be given with better grace than if it is asked for later with all the appearance of an after-thought. Where figures have to be examined in some detail it is advisable to defer full discussion until a second interview at which the presence of the customer's accountant will be invaluable. The contact thus made often enables the manager to clear up later queries direct with the accountant and with a minimum of trouble to the customer himself.

¹ *Business Balance Sheets*, F. R. Stead.

If the proposition is one the nature of which is outside the branch manager's own experience it cannot be too strongly urged that the advice of the Head Office advance specialist should be sought at the earliest possible moment and preferably before a second interview. Of necessity the latter's experience of all types of business will be wider than that of the branch manager, and he has at his disposal sources of information and assistance far more comprehensive. So often, where the manager is out of his depth and still tries to shape the proposal unaided, he will have to go back to his customer again and perhaps again for further information. This will at once irritate the customer and discredit the manager who should at all times be jealous of his position as the representative of the bank on the spot. He should endeavour to speak always with the voice of his bank; any avoidable reference at the interview to 'my Head Office' cannot fail to undermine his standing in the customer's eyes. The customer is quick to realize when the manager is a mere 'Post Office' between himself and the Head Office: and is equally ready to be impressed when the manager handles the matter like a real banker.

The purpose of this chapter is to examine the extent and nature of that full information which a banker requires before he can give his decision. While it will confirm the impossibility of basing such a decision upon the accounts alone, it will show that nearly every further question is related to and often prompted by those accounts. Their place, their proper place, in bank lending will then be seen in clearer focus. The order in which the following points are set out has no significance: they may all be equally important in practice.

(1) HOW MUCH?

Generally it is for the customer to indicate his requirements: not for the banker to say how far he is prepared to go. What the Head Office want, and are entitled to, is a proposition thoroughly hammered out in the manager's room after the manager has shaped it *as a banker*. But at whatever level the decision has to be given, whether at the branch or in the board room of the bank, the same rule applies: the customer should submit his complete proposal.

(2) WHY DOES THE CUSTOMER REQUIRE BANK ASSISTANCE?

The last balance sheet may show a satisfactory liquid position: the banker will want to know what factors have brought about the need for further cash. Here up-to-date figures, preferably furnished by the accountant, may shed some light. Has working capital been depleted by the purchase of fixed assets, by dividends, by directors' fees, or by the repayment of fixed liabilities? Is the work-in-progress figure swollen: if so, why? Are there bottle-necks in production? Is the business over-stocked: if so, again, why? The causes may be over-trading, the development of consumer resistance or the emergence of competitive lines at more attractive prices. Have losses been made? Is current trading profitable?

(3) WHAT WILL THE BANK'S MONEY BE USED FOR?

This question must be considered in the light of the following comments:

- (a) Money borrowed to pay *taxation or dividends* will be money lost to the business and the advance will not have that self-liquidating character which commends itself to any lender of short-term money. If the business could not find cash to meet these requirements will it be able, with any less difficulty, to find cash to repay the bank?
- (b) Money lent to pay creditors may be sound business if it is to enable the company to secure discounts for prompt payment.¹ If, however, creditors are pressing it may be quite the reverse. If receivables do not enable liabilities to be met promptly as they fall due, the question of the adequacy of receivables to service the bank advance must be examined.
- (c) Money required to finance stock or debtor tie-ups should not be lent without close enquiry into the whole cash position. The banker will want to know why turnover and collections are slow. Where the money will be lent to subsidiaries special care is

¹ See note on cash discounts in previous chapter, page 196 *ante*.

necessary. It is, however, often sound business to borrow from the bank in order to finance a special buying opportunity, promising a quick return.

- (d) Generally the raising of further cash to finance increased turnover will be sound business, but the banker should be on his guard against incipient over-trading. Often the lending will be justified if there has been a temporary change-over in the business from short- to long-term contracts. If such change-over is permanent, it becomes a question of more permanent capital.
- (e) Advances granted to repay loans or capital are open to the criticisms noted in (a) above. The result is often that the bank will merely stand in the shoes of the loan creditor and with just as little chance of reductions out of liquid resources as his predecessor had. Nevertheless, there will be many occasions where such lending is quite satisfactory: each proposition must be judged on its merits.
- (f) Advances for the purchase of fixed assets may be quite sound business provided:
 - (i) there are ample resources to finance any increased turnover which may result; and the transaction does not also involve an undue depletion of the working capital; as when the company is borrowing the loan value of the assets and finding the equity itself;
 - (ii) reasonable reductions are in prospect and the element of permanent lock-up is avoided.

There should be strong reasons for any departure from the sound rule that all fixed capital should be provided by the proprietors or long-term lenders, as well as at least a portion of the working capital. Here again the case must be judged on its own merits.

(4) WHAT IS THE NATURE OF THE BUSINESS?

- (a) Any advance is to a business, not to a balance sheet. The banker will want to know whether the business is firmly established; with a good record; showing a

satisfactory net return; and with a sound financial position. The trend of profits is significant; for 'deficiencies in the balance sheet may be outweighed by substantial and steadily growing profits reflected in the income account. A thriving business with growing profits is a more satisfactory credit (risk), even if the ratio of current assets to current liabilities is comparatively low, than a concern showing a liberal margin of assets, but a dwindling Profit and Loss Account. One is growing constantly stronger, the other less and less desirable as a risk. One inspires confidence, the other apprehension'.¹

- (b) How far does the success of the business depend on special contracts or concessions or a monopoly in a particular field? Contracts and concessions will terminate and a virtual monopoly may be undermined by new inventions and discoveries. Phillips refers to 'the case of a company that showed a statement of such character that on it as a single basis any banker would have been tempted to advance funds freely. Assets were large, net worth was large. Earnings for a period had been strikingly good. Investigation, however, disclosed the fact that a lucrative contract, which was the basis of the concern's large earnings and then flourishing condition, was about to expire without possibility of renewal'.²
- (c) How far are the operations of the business confined to established lines? It may be attempting to exploit a new invention or to launch a new product. The risk of any such venture is normally not a banker's, but a proprietor's, risk. The invention or new product should first be *proved* at the expense of the company: then, and not until then, should the banker come in to finance further development. To use a simple illustration, it is for the customer to buy the vehicle and test it on the road: then the banker may be asked for some help to extend its range of operation. Inventors are notorious optimists. The banker must be on his guard against becoming involved too soon.

¹ *Bank Credit*, C. A. Phillips.

² *ibid.*

- (d) What are the prospects for the applicant's *kind* of business? The banker's knowledge of affairs is usually wide enough to warn him when certain industries or commercial activities are running into difficulties. Sometimes it is farming which is in the doldrums; now the building industry; then motor servicing and garage business; later perhaps light engineering; or hotels. Budgetary and other Government measures are potent influences today. Instinctively the ideal banker senses when the time has come to walk warily.
- (e) What are the prospects for that *particular* business? The factors to be considered are the quality of its management; the political and economic state of the normal market for its particular goods or services; and the suitability of its location in relation to supplies, transport, labour, and markets. Many a banker will be able to recall cases where a business – sometimes on the largest scale – has failed because it was opened on the wrong side of the street.

(5) EFFECT ON THE BALANCE SHEET

How will the balance sheet look when the advance has been taken and used in the way proposed? This should always be considered with care. A balance sheet is a matter of nice equipoise. Will the balance of fixed and current assets be upset? Will the working capital be increased or decreased? The more far-reaching or complicated the proposal, the more important is this second look at the balance sheet.

(6) WILL THE ADVANCE BE ENOUGH?

There is nothing a banker dislikes more than to put his hand to the plough and be unable to see it through to the end of the furrow. On occasions he has to say, 'You ask for £10,000. It is not enough. I will lend £20,000 or nothing. Let us see if £20,000 can be justified.' Obviously it is unwise to agree to the £10,000 only to find that in six months time the alternative is to break the business or put up more money. The long view will ensure that the banker does not become

involved until the full extent of his possible commitment has been explored. It is here that the working capital ratio provides, if not an absolute criterion, at least the starting point for a carefully worked out budget for as long a period and in such form as the nature of the proposal requires. A cash budget month by month is often helpful. A fifty per cent addition to the peak bank advance disclosed will not usually provide any too wide a margin for contingencies. An actual method of working out the figures will be explained in the next chapter.

(7) THE SOURCE OF REPAYMENT

It must be stressed once more, in connection with the questions a banker should ask before making or enlarging an advance, that basically, bank lending should be temporary. It is not a bank's function to embark with its eyes open upon lock-up lending. No banker should make a house-purchase advance to a widow of slender means if he knows (or should know after making suitable enquiries) that he can only obtain repayment by turning her into the street or waiting until she dies. The first will involve damage to his reputation; the second the surrender of essential banking liquidity. Exactly the same considerations apply to large-scale advances to companies. Before the advance is made is the time to remember that reductions or repayment can only come from:

- (i) Non-revenue receipts;
- (ii) Conversion of circulating assets into cash;
- (iii) Cash profits *after tax*.

Excepting to the extent that circulating assets are standing at, or will be built up to, an abnormal level, source (ii) can only produce reductions by a running down of the scale of operations.

'Over and above any legitimate trade credit that may be obtainable there is a certain minimum amount of resources demanded by the exigencies of every business; and that minimum should be represented by shareholders' capital, or by borrowings of a permanent nature. Any temporary excess for a specific purpose might be met by a banker's loan or in

some other way; but if, through expansion of business or from any other cause, the minimum is permanently increased it immediately becomes a capital question. For obvious reasons it is usually unsafe and unbusinesslike to borrow for permanent requirements by way of temporary loan; and in any case it is no part of the functions of a bank to provide capital for its customers.¹ The attitude of bankers may have been modified since these words were written, but the difference is one of degree, not one of principle.

(8) *RATE* OF REPAYMENT

The examination of the rate of repayment involves two considerations:

- (a) What period of profitable operation can be relied on in view of the nature of the business? This is of paramount importance where it depends on patents, concessions, rapidly wasting fixed assets, or generally on the temporary nature of the conditions essential to the earning its profits. It is often possible to say that the advance is justified only if it can be repaid in, say, five years. That brings us to the second question;
- (b) Will the rate of reductions considered essential under
 - (a) be within the capacity of the business? If not, clearly the banker will ask to be excused. In considering the many imponderables involved – the rate of profit, the risk of competition, the possibility of fiscal changes, the chances of heavier or lighter controls – the banker may properly give some weight to
 - (i) the scope for curtailing dividends or drawings if his requirements cannot otherwise be met. Where such drawings are already small the banker must normally rely on actual profits after tax to meet his requirements;
 - (ii) the cushion provided by the solid fixed assets.

¹ *Business Balance Sheets*, F. R. Stead.

(9) THE PROPORTIONATE STAKE

At every stage in the granting or control of a bank advance, the banker must be on his guard against having too large an interest in the success of the business. No banker can reasonably be asked to play with the business community on the basis of 'Heads I win, tails you lose'. Bank finance is cheap, perhaps the cheapest of all forms of finance, and whilst finer rates may be quoted for lending against first-class security even the banker's highest remuneration is not assessed on a risk-bearing basis. The proprietors' or shareholders' stake, as represented by the net worth figure, must therefore always be large enough to cover the area of risk. If the business succeeds the proprietors reap the reward of their enterprise and efficiency; if it fails they should stand the loss. The banker asks no more than his modest interest and a reasonable remuneration for his services. He is certainly entitled to ensure that the commercial risk, which he is not paid to carry, is squarely borne on other shoulders. Kaleidoscopic changes, as swift as they are startling, sometimes catch him unawares: then losses are made. But the principle is sound: the proprietors' stake should cover the foreseeable risks.

(10) SECURITY

When the customer has formulated his requirements perhaps the first question the banker would ask in reply would be, 'What security do you offer?' Until this is known and its value is assessed, the banker cannot even begin to consider how much can be lent. It will suffice here to point out that where third party security is lodged, conferring a right of double proof,¹ the banker may be ready to go a little further than if the same security were lodged by the actual borrower. The general consideration of various types of security is outside the scope of this book: but 'the margin required ought always . . . to be sufficient to throw the burden of value fluctuation on the shoulders of the borrower'.²

¹ Briefly this means that in the event of bankruptcy or liquidation the banker can prove for the full amount of his debt against his debtor's assets and still look to the full value of the third party security for any short-fall.

² *Bank Credit*, C. A. Phillips.

(II) CHARACTER

"The credit worth of a borrower, which may be defined as the amount which he will be able to repay at maturity or to the reasonable satisfaction of the lender, depends on three factors: capital . . . capacity and character."¹ Phillips thus looks to the people behind the business for two out of his three main criteria. There is no error of emphasis here; the personal evaluation by the lending banker is crucial.

- (a) *Integrity* is the first consideration, and not mere fair-weather integrity. In any advance which is not fully secured on solid saleable assets, and particularly in an advance where substantial amounts are lent against current assets under a floating charge, the lender has to rely on periodical figures supplied by the directors (certainly as regards stocks and work-in-progress) and is very much in his customer's hands. The most reliable and docile of creatures may become nasty when cornered: adversity is the real test of character.

One case – fortunately not of a kind which occurs frequently – comes to mind where a receiver was appointed under a debenture. Before he could take over the stock which should have been ample to clear the bank debt it was spirited away and some of it was finally tracked down hidden in empty bricked-up shops all round the perimeter of London. Debtors had been collected with a similar disregard of normal business honesty: no doubt it was felt that the bank was fair game.

The accounts of a private company will sometimes show that the business has been milked by the directors, a potent cause of deficient working capital. Where this has been carried so far that the safety of the creditors is threatened it verges on dishonesty.

- (b) *Business Capacity* is almost as important. The bad debt experience of the banks would be happy indeed if losses were made only when dealing with rogues. Serious and frequent losses arise also from incapacity

¹ *Bank Credit*, C. A. Phillips.

which will now be considered under three sub-headings.

- (i) *Inexperience.* The past record of the persons responsible for a business which seeks financial assistance from a bank should always be closely examined. They may be jacks-of-all trades and masters of none. The rolling stone is a poor credit risk. Such weaknesses should be apparent to any alert banker. What is not so easy to detect is the risk of failure in a new enterprise of people who have been successful in their previous line of business. It requires nice judgement to decide whether a retired stock broker will succeed as a farmer, or an ex-army officer as an hotel-keeper. No rules can be suggested; but the closest enquiry into the borrower's background is essential.
- (ii) *Financial acumen.* The lack of financial experience can wreck a sound business. Technical knowledge, drive and energy are not enough. The banker can often save himself and the customer worry and even loss by judicious advice; or by recommending a knowledgeable partner or introducing a sound accountant. Even then he has to assess the extent to which his customer can be relied on to accept and follow sound advice. This brings us to the third consideration.
- (iii) *Defects of Temperament.* There are many characteristics which can make a borrower a poor credit risk. Pig-headedness will keep a man on his chosen course long after he should have recognized its unwisdom; over-trading is one such course. Greed, an anxiety to get-rich-quick and 'hang the risk', is nearly always dangerous.

Allied to a gambler's temperament it may be fatal. Reluctance to cut a loss, often allied to a facile optimism, is a menace to customer and banker alike. To some, early success and achievement is a heady wine encouraging the pride that goes before a fall. The man who is reluctant to take his coat off and expects to start half-way up the ladder may be quicker to borrow than to repay.

The moral of all this is, 'Know your man.'

CHAPTER XV

THE PRACTICAL CONTROL OF BALANCE SHEET ADVANCES

Accounts Record Form – Its Value in Use – Adequacy of Facilities – Importance of Clear Lending Basis – Interim Figures: Their Nature and Use – The Importance of Wages – Loans by Directors – Creditors' Reaction to Debentures.

ADVANCES in which the main consideration is the Balance Sheet position fall into two main classes. There are those where the position is so manifestly sound that the advance can be left to take care of itself. No security whatever is considered necessary and the annual balance sheets suffice. There are those where a debenture is taken and reliance is placed not only upon a charge on the fixed assets but also upon a floating charge over the current assets. Where the lending is against current assets to any substantial extent, quarterly or even monthly figures are desirable: the nearer to the risk-line, the closer the supervision necessary. Much of this chapter will be devoted to the figures which are necessary – throwing a progressively wider net as the need for watchfulness grows – and to the use which can be made of such figures.

Whether, and how frequently, confirmation of interim figures by the company's auditors is required, or by investigating accountants appointed independently by the bank, depends largely upon the extent of the lending and the banker's estimate of the reliability of the management and the standing of the company's own auditors. It has already been pointed out¹ that normally little direct protection is afforded by an auditor's certificate as far as the stock figures are concerned. There is no doubt, however, that in certain cases the fact that accountants (whether the company's or appointed by the bank) will furnish certificates to the bank which will be placed alongside figures already provided by the directors, will often have a salutary psychological effect.

¹ Chapter IV *ante*.

An accountant's interim report is therefore a safeguard not to be discarded lightly.

ACCOUNTS RECORD FORMS

The starting point of all balance sheet advances is a series of accounts, preferably for three or more years, which should be uniformly analysed and recorded in a way which will facilitate year by year comparisons and bring to the surface the salient points of both Balance Sheet and Revenue Accounts. The ideal form, as far as the balance sheet is concerned, would be that set out in Chapter II, Example II, but it would require a double column for each year, and some compactness and ease of comparison with the figures of previous years would be sacrificed. Example XXIV shows the compromise form recommended by the author, completed for 'Manufacturers Limited' for the three years to 31st March 1948. The balance sheet for the first year (Example I) and the working capital figures for the three years (Example X) have already been given: those who are interested will find the complete accounts for the three years in Appendix II.

Example XXIV

ACCOUNTS RECORD FORM

CUSTOMER:

'MANUFACTURERS LIMITED'

	1946	1947	1948
	£	£	£
I CURRENT LIABILITIES			
Bank	—	—	5,000
Taxation (current)	12,000	10,000	14,000
Creditors	5,000	17,000	43,000
Provisions	5,000	15,000	10,000
Bills Payable	—	—	—
Loans	—	—	—
Total Current Liabilities	22,000	42,000	72,000
LONG-TERM LIABILITIES			
Mortgages	—	—	—
Debentures	70,000	70,000	70,000
Loans	—	—	—
Reserves for future taxation	—	—	—
NET WORTH			
Capital	100,000	100,000	100,000
Reserves	30,000	30,000	30,000
Profit and Loss Account	10,000	14,300	14,300
	232,000	256,300	286,300

	1946	1947	1948
	£	£	£
II CURRENT ASSETS			
(a) <i>Liquid Cash</i>	9,000	10,000	—
Marketable Investments	8,500	—	—
	<hr/>	<hr/>	<hr/>
	17,500	10,000	—
(b) <i>Circulating</i>			
Debtors	24,500	17,000	17,000
Bills Receivable	2,500	5,000	—
Stock	25,000	50,000	60,000
Work-in-progress	7,500	15,000	50,000
	<hr/>	<hr/>	<hr/>
Total Current Assets	77,000	97,000	127,000

FIXED ASSETS

Freeholds	98,600	98,600	98,600
Leaseholds	—	—	—
Plant and Machinery	50,000	55,000	55,000
Transport	—	—	—
Fixtures and Fittings	5,000	5,000	5,000
Investments (Not Marketable)	—	—	—
Loans	—	—	—

INTANGIBLE ASSETS

Discount on Debentures	1,400	700	700
Goodwill	—	—	—
Directors' Borrowings	—	—	—
Adverse Profit and Loss	—	—	—
	<hr/>	<hr/>	<hr/>
	232,000	256,300	286,300

III BALANCE SHEET NOTES

¹ True 'Net Worth'	138,600	143,600	143,600
Working Capital	55,000	55,000	55,000
Current Ratio	3.5	2.3	1.75
¹ (after deducting Intangible Assets)			

REVENUE ACCOUNT NOTES

Sales (or production)	212,000	390,000	354,000
Gross Profit	97,000	87,250	49,000
Gross Profit, per cent	45.8	22.4	13.9
Overheads	41,900	33,500	28,500
Net Profit (before taxation)	56,600	53,750	20,500
Drawings or Dividends (net)	25,000	25,000	10,000

Without unduly enlarging the analysis it is not possible to record on the Accounts Record Form all the matters of interest. Essentials only have been retained. The vital totals

of current liabilities, liquid assets and current assets can be seen at a glance. The main classes of Liabilities and Assets are clearly segregated. The net worth items appear separately at the end of the first section; the intangible assets which should be deducted therefrom, to ascertain the true net worth, are last in the second.

The third section is invaluable. A word is, perhaps, desirable regarding the Revenue Account figures. The figure – Sales (or production) – will indicate the magnitude of the total operations for the year, and can be usefully compared with the working capital position. An expansion in turnover without an expansion in cash resources can be embarrassing, and even dangerous. If there has been a material rise (or fall) in the amount of work-in-progress during the period the amount of such rise (or fall) must be added to (subtracted from) the sales figure to ascertain the true out-turn of the business.

The inclusion of the overheads (which is the total of the debits to the Profit and Loss Account) focuses attention on the most important source of gross profit leakage. If net profit plus overheads exceed the gross profit shown, it indicates non-trading credits in the Profit and Loss Account which should be referred to if the difference is of significant amount. No attempt has been made to devise headings for the Appropriation Account as the items may vary a great deal from year to year. Only the most significant figure, dividends or drawings, has been extracted. If the remaining amount of net profit (not shown) does not agree with the increase in the final Profit and Loss Balance in Section I, the Appropriation Account itself should be referred to for the explanation.

The following notes will demonstrate how this Accounts Record Form can be read: the salient points are:

(1) The progressive disappearance of the liquid assets: £17,500, then £10,000, then bank overdraft, £5,000.

(2) The marked fall in the current ratio.

(3) A very definite deterioration in the liquidity of the circulating assets. Expressed as percentages of the total current assets, the figures are:

	Year I to 31/3/46	Year II to 31/3/47	Year III to 31/3/48
	%	%	%
Liquid Assets	23	10	—
Debtors	32	17	13
Bills Receivable	3	5	—
Stock	32	52	47
Work-in-progress	10	16	40
	<hr/>	<hr/>	<hr/>
	100	100	100
	<hr/>	<hr/>	<hr/>
Current Liabilities	29%	43%	57%

(4) The upward trend of stock and work-in-progress is out of step with the fall in debtors: they should all rise together if the business, i.e. both production and sales, is expanding normally.

(5) The fall in debtors in Year II is out of step with the increased sales and suggests a big falling off in sales in the last few months of the financial year, and possibly pressure to increase collections.

(6) In step with increased stocks, creditors have increased faster than debtors.

(7) Bills receivable, which in Year II rose with sales, disappeared in the following year. The suggestion that they may have been discounted is borne out by a footnote to the 1948 balance sheet.¹

(8) There does not appear to have been any provision for depreciation of plant and machinery and the other fixed assets in Years II and III, in spite of the increased production and probable increase in actual wear and tear. This is confirmed by the accounts themselves.¹

(9) Nothing is written off Discount on Debentures in Year III.

(10) There was insufficient cash in hand to meet the final dividends in Years II and III. In the latter year the proposed dividend could only be paid by substantially increasing the bank overdraft. In each year adequate profits had been made *but not realized in cash*.

¹ Appendix II.

(11) In spite of the increased sales and (from the accounts¹) production in Years II and III, both working capital and net worth remained static. The capital resources have not kept pace with the expansion of the business.

(12) The apparent fall in overheads is revealed by the accounts¹ to be due to the omission of depreciation provisions in Years II and III.

(13) The fall in net profit is due to the fall in the gross profit: had adequate depreciation been charged, the fall in net profit would have been greater. In Year III the net profit might well have disappeared altogether, and no dividend could properly have been declared.

(14) Looking to the accounts¹ for the explanation of the fall in gross profits, it will be seen that in Year II the main fall was in the factory profit, while in Year III both factory and merchanting showed reduced profits, the greater fall being in the latter.

(15) A reasonable general inference from the figures is that

- (a) the first year was normal, the second opened in boom conditions under which a large expansion was initiated,
- (b) towards the end of Year II conditions deteriorated, production was affected, and sales began to fall away,
- (c) in Year III a slump developed, and sales resistance caught the company in an over-stocked position,
- (d) the fall in the rate of trading profit is consistent with a break in selling prices, affecting both sales and stock valuations.

SOME USES OF THE RECORD FORM

From an examination of the Accounts Record Form alone it is therefore possible in practice to detect many material trends. It will nearly always repay close and thoughtful study.

¹ Appendix II.

But, as the foregoing analysis will have made clear, its main value lies in directing the banker to the accounts themselves for further information.

In one instance it was noted that the stock figure in the accounts of a manufacturing company, which was earning good profits, was rising steadily year by year, without any corresponding increase in sales. Nor was there an excessive increase in creditors, or a loss of swing in the bank account, from which over-trading could have been inferred. Enquiry revealed that the stock growth was accounted for mainly by the accumulation of a by-product for which there was no outlet, valued year after year on the basis established when there had been a ready market. The banker thus found that his lending value for the stock had to be drastically reduced. But he did more. He put his customers into touch with a live firm of Chartered Accountants who were able to persuade the Inland Revenue that for years past profits had been overstated by reason of the progressive over-valuation of stock and that a substantial refund of taxation was due to the company. Later he contacted some industrial friends who were able to use the by-product. The result was the receipt of much-needed cash capital and a permanent addition to the company's profit-earning capacity: and for the bank a satisfactory advance in place of one which had begun to give some cause for anxiety.

In Chapter XIII some comments were made on over-trading following a succession of trading losses and consequent depletion of the company's working capital. The salient figures have been extracted from the Accounts Record Form of such a company and are set out on page 223 (Example XXV).

The following points will be noted:

- (1) In only one of the eight years has a net profit been made.
- (2) The main cause is high and apparently irreducible overheads.
- (3) As a result of the accumulated losses the bank's stake increased in the period from 66% of the net worth to 361%.

- (4) The bank overdraft had been held at £18/19,000 only by diminishing the scale of operations and with disastrous effects upon production and upon the burden of overheads per unit of production. The tie-up in debtors and work-in-progress at the end of 1947 represented no less than 78% of the total year's production (£29,480, made up of sales £26,750, plus increase in work-in-progress, £2,730).
- (5) The marked fall in creditors out of step with falling production suggested the curtailment of credit on a substantial scale.

At an interview the managing director stated that production could easily be expanded by 60% if the bank would grant increased facilities of, say, £5,000. Accepting the company's figures as a basis for investigation, the banker was able to present the following picture.

				£
1937 Turnover	.	.	.	29,500
60% Increase	.	.	.	17,500
				<hr/>
Estimated Turnover	.	.	.	£47,000
				<hr/>
Gross Profit thereon @ 25%	.	.	.	11,750
Less 1937 Overheads	.	.	8,400	
Estimated increase (say				
30%)	.	.	2,520	
Increased Bank Charges			250	
			<hr/>	11,170
				<hr/>
Estimated Net Profit	.	.	.	£580
				<hr/>

Even on this optimistic estimate, based on an expansion which would involve a great deal more work and worry for the management, there would only be a profit of £580 to provide a reward for the extra work and for reductions in the bank borrowing. But the suggested scheme had to be rejected on two grounds:

- (a) The bank's stake in the business was already excessive;
- (b) The £5,000 asked for would not be nearly enough. On the 1947 figures an increase of £17,500 in production would require £11,500 more working capital, calculated as follows:

Example XXV

EXTRACT FROM ACCOUNTS RECORD FORM OF 'XYZ LIMITED', CONTRACTORS

	1940	1941	1942	1943	1944	1945	1946	1947
Bank Overdraft	£ 8,448	£ 11,114	£ 13,918	£ 20,170	£ 16,524	£ 17,826	£ 18,868	£ 18,348
Creditors	3,920	4,820	4,370	5,020	5,380	7,085	2,300	3,620
Debtors	10,400	13,100	13,200	10,600	9,500	11,600	9,500	6,040
Work-in-progress	9,750	15,050	14,350	20,970	16,370	17,100	14,400	17,130
Adverse Profit and Loss	3,200	2,500	3,140	5,850	8,210	8,900	10,200	11,800
True Net Worth	12,670	13,280	12,730	10,020	7,660	17,968	6,668	5,076
Sales	45,000	40,000	34,500	41,000	28,400	39,800	36,200	26,750
Gross Profit	8,550	8,200	7,212	5,802	5,446	7,374	7,104	6,816
Per cent	19	20½	21	14½	19	18½	21	25
Overheads	9,930	7,588	7,760	8,516	7,804	8,066	8,402	8,408
Net Loss	1,380	612	548	2,714	2,358	692	1,298	1,592
		(Profit)						

¹ Share Capital increased by £1,000.

	£
60% Increase in Debtors and Work-in-progress	13,650
Less Increased Creditors, 60% of £3,620	2,170
	<hr/>
Increased Working Capital required	£11,480
	<hr/>

It was not possible for the proprietors to find the necessary new money, even if it could have been justified on business grounds. With the support of the company's accountant it was not difficult to convince the directors that they were 'flogging a dead horse' and the interview terminated with an agreed decision for the bank to put in a receiver and manager under its debenture, with the full co-operation of the company. The position had long since been reached when the only way in which the bank borrowing could be cleared was by the winding up of the business; it was only because the character of these old customers was first class that the decision taken had been deferred. A position of acute over-trading had been brought about by progressive shrinkage of working capital, the result of successive losses.

A strong argument available in this case was that the managing director was already working near breaking point for a mere pittance, which was all the business had been able to afford for years: and the suggested expansion would have produced a negligible reward for even greater efforts. It was agreed that only one criticism of the bank could possibly be made: that it had carried an obviously deteriorating position for far too long.

Not in all such cases is it possible to wind up a difficult account so amicably or for the bank to extricate itself without loss. This example underlines the value of the presence of the company's accountant at the discussion; and often, as in this particular instance, his appointment as receiver ensures the continuity of management and the smooth blending of personalities so essential to the satisfactory realization of a substantial volume of work-in-progress.

Studied with that real understanding of business accounts which it has been the object of the previous chapters to promote, an Accounts Record Sheet will 'talk'.

ADEQUACY OF FACILITIES

The need to test at the outset the adequacy of the facilities sought for the purpose of financing an increased turnover has already been stressed in the previous section of this Chapter and in Chapter XIV. An actual case will illustrate the necessary calculations.

Example XXVI

In August 1948 'Home Supplies Limited' seek an overdraft of £10,000 to finance the purchase of a factory £10,500 and additional plant and machinery £4,500 and to finance an increase of £12,000 (say 20%) in turnover, guaranteed under firm long-term fixed price contracts; and produce the following accounts. A regular supply of raw materials is assured. It will take three months to establish the increased production in the new factory.

Manufacturing Account. Year ended 30th June 1948

	£		£
Opening stock . . .	325	Sales	53,064
Purchases	22,654	Increase in Work-in-progress	1,759
	<u>22,979</u>		<u>1,759</u>
Less closing stock . . .	278	Total Production . . .	54,823
	<u>22,701</u>		
Materials used	22,701		
Wages	15,775		
Other expenses	950		
	<u>39,426</u>		
Cost of Production . . .	39,426		
Manufacturing Profit (28%)	15,397		
	<u>£54,823</u>		<u>£54,823</u>

Profit and Loss Account

	£		£
Directors' Fees	1,600	Manufacturing Profit . .	15,397
Rent	500	Sundry Receipts	376
General Overheads	6,525		
Net Profit	7,148		
	<u>£15,773</u>		<u>£15,773</u>

Appropriation Account

	£		£
Proposed Dividend 50% (Net)	1,380	Balance from last year	1,462
Taxation Provision	3,600	Net Profit	7,148
Balance	3,630		
	<hr/>		<hr/>
	£8,610		£8,610
	<hr/>		<hr/>

To meet the £15,000 cost of the additional fixed assets, the customers propose to borrow £10,000 from the bank, utilizing £5,000 of their existing cash resources to cover the balance; and to reduce the overdraft of £10,000 by £1,500 in the first year out of the anticipated increased profit, say 28% on £12,000 = £3,360.

The Working Capital Ratio,

$$\frac{8,300}{54,823} = 15.2\%$$

will provide a check on the adequacy of the amount sought.

	£	£
15.2% of increased turnover, 12,000		1,824
Add precautionary 50% margin (say)		1,000
		<hr/>
Additional working capital required		2,824
Fixed assets to be bought	15,000	
Add legal expenses (say)	300	
	<hr/>	15,300
		<hr/>
Total additional capital required		18,124
Less Cash available	6,628	
Less Dividend	1,380	
	<hr/>	5,248
		<hr/>
Overdraft necessary		£12,876
		<hr/>

This rough and ready check, which brings into account certain items omitted by the customer, indicates that the £10,000 sought will not be enough, and prompts the further analysis of the position which is set out overleaf.

CASH REQUIREMENTS

Present cash in hand	£	6,628	Purchase of factory	£	10,500
Overdraft required <i>now</i> to balance	£	12,552	<i>Legal costs</i>	£	300
			Plant and machinery	£	4,500
			<i>Installation costs</i>	£	500
			Dividend	£	1,380
			Minimum cash in hand	Note (iii)	£17,180
					£2,000
			Required <i>now</i>		£19,180

ESTIMATED CURRENT POSITION BY END OF YEAR 30TH JUNE 1949

	£	£	£	£
Provided by				
Cash at bank	.	.	6,628	.
Estimated net profit as last year	.	.	7,148	.
Add gross @ 25% on £12,000 for nine months	.	.		.
Saving in rent	.	.	2,250	.
			500	.
Total brought down	.	.		.
Taxation	.	.		.
Increase in normal overheads (estimated)	.	.		.
Bank charges	.	.		.
Loss of profit due to transfer to new factory (estimated)	.	.		.
				19,180
				2,817
				1,300
				700
				1,000

Note (1). For the purpose of this calculation a conservative 25% gross profit has been assumed on the increased turnover for the nine months, instead of the 28% earned in the previous full year.

Note (ii). This is a *cash* analysis consequently a deduction must be made for cash absorbed in increased non-liquid assets.

Note (iii). On the footing that £2,000 is kept available in case of need, but is not actually required at 30th June 1949, the overdraft will be £2,000 less at £7,611, as shown in the balance sheet which follows.

20% increase in circulating.	
Expense	260
Trade	800
	<hr/> 1,060
Note (ii) Deduct 20% increase in circulating assets	
	17,586
	<hr/> 2,200
Note (iii) Closing bank overdraft (to balance)	
	15,386
	<hr/> 9,611
	<hr/> £24,997

These figures foreshadow the following balance sheet position in June 1949:

Capital	£	5,000	Fixed assets:	£	
Profit and loss (subject to tax on £6,898)	.	10,528	Goodwill . . . . .	.	1,750
		<u>15,528</u>	Freehold factory at cost . . . . .	.	10,800
			Plant and machinery at cost . . . . .	.	7,164
					<u>19,714</u>
Current liabilities:					
Creditors . . . . .	.	6,322			
Taxation . . . . .	.	3,600	Circulating assets . . . . .	.	13,347
Bank Overdraft . . . . .	.	7,611			
		<u>£33,061</u>			<u>£33,061</u>

Working capital (£6,000 of overdraft being treated as long term), £1,800

This estimated balance sheet is subject to provision for taxation on the profits of the year, which will not however affect the cash position immediately. This analysis shows that the original estimate of £10,000 as the peak requirement is totally inadequate: £13,000 will provide none too large a margin. A reduction of £6,000 will be possible by the end of the first year provided no dividend is paid, but the bank can safely agree to a lower rate of annual reduction. Assuming that the factory is not specialized, that the business is soundly established and that the prospects are good, an advance might be made on the following terms:

- (1) Security a debenture with first fixed charge over the factory and a floating charge over all the other assets.
- (2) Lending basis £6,000 against the factory, any excess, *up to a total of £13,000*, to be covered at all times by twice the amount of current assets.
- (3) As, in the early stages when the overdraft will be at peak, the current assets (excluding the cash which will be withdrawn) amount to £11,000 only, the debenture will give cover for not more than £11,500, a joint several guarantee of the directors should be taken for the full amount of £13,000, supported by security with a lending value of at least £3,000. Such a guarantee is always of value as an expression of confidence by the directors and to ensure their personal interest in the carrying out of the programme of reductions.
- (4) Figures of current assets and liabilities to be furnished monthly.
- (5) Directors' drawings not to be increased, and no dividend to be paid without the concurrence of the bank.
- (6) Minimum annual reductions of £2,500.

Condition (5) is perhaps superfluous in this instance, but is included as a reminder of its importance in many cases.

It may be objected that at £13,000 the bank's stake in the business is disproportionate to the Net Worth of £8,630 at 30th June, 1948. But the profit record is satisfactory and there

is a sound fixed asset cushion; moreover, with the supporting security the proprietors' stake is in excess of £11,630; and, above all, the prospects of reduction are reasonably good.

LENDING BASIS

It cannot be emphasized too strongly that the basis of lending must be clearly defined, and understood by the customer as well as the bank. There should be a yardstick against which the position of the account can be checked at any time. Some of the most difficult problems arise in practice, not from dishonesty but from genuine and avoidable misunderstandings of the lending basis, or of the fact that it only operates under a fixed ceiling – in the example just quoted, £13,000. The writer has known several cases in which the customer has meticulously maintained the stipulated current asset cover but, when over-trading conditions have begun to develop, has forgotten the over-all limit. The best way to explain the terms of lending agreed to in this Example is – the bank wishes to restrict the total advance to £13,000: within that maximum the lending basis will apply. The effective limit from time to time will therefore be £13,000 or the lending figure determined by the monthly current assets statement, *whichever is the lower*.

Advances may of course be made unsecured to companies with exceptionally strong balance sheets, where no lending formula is laid down or required, and the banker is content to dispense with interim figures; but in many cases these are a *sine qua non*.

The make-up and use of interim figures in advance control will now be discussed.

INTERIM FIGURES

(1) CURRENT ASSETS ONLY

Even when the agreed lending basis does not involve any direct reliance upon the current assets under a debenture, the regular furnishing of interim figures provides a useful and desirable barometer of current trading. The usual bank debenture contains what is known as a maintenance clause

which incorporates an undertaking by the company to maintain the aggregate of its stock, good book debts and cash at a fixed figure or at a stated margin over the bank debt, and to furnish a certificate of the amount at specified intervals. Its minimum requirement is therefore a periodical certificate 'in the terms of the clause . . . of the debenture dated . . . the aggregate of the company's stock, good book debts and cash on . . . amounted to (or was not less than) £x . . .'. There may be accounts where this will suffice, but no watch on changes in the make-up of the current assets will then be possible. It is usual, therefore, to require at least separate totals for:

Work-in-progress,
Stock,
Debtors,
Cash,

in such detail as the nature of the business and the generosity of the bank lending require. A reminder may not be out of place here that the debtors and work-in-progress figures should be net (i.e. after deducting any set-off amounts included in the company's creditors): retentions should also be excluded.¹ *Estimated* figures for stock or work-in-progress should always be viewed with suspicion especially if the same figures appear unchanged month after month.

It must be borne in mind too that claims under a floating charge in a debenture are postponed to any creditors which, in winding up, would be preferential. This is one reason why at intervals full schedules of debtors and creditors are desirable. If only the current assets figures are furnished, the existence and effect on the position of preferential creditors will not be disclosed. Nevertheless the figures alone are not without value, as the following example (Example XXVII) shows.

The lending basis was Limit £22,500, £4,500 against a fully supported guarantee, the balance up to £18,000 not to exceed 50% of the current assets.

Throughout the six months' period the account was therefore within the lending basis, but the following points are noticeable:

¹ See Chapter IV *ante*.

- (a) The increasing use of the bank facilities;
- (b) A fall in debtors, suggesting a reduction in sales – debtors have fallen from highest figure of 30% to 16% of the total of the total current assets;
- (c) A parallel increase in work-in-progress and stock;
- (d) At the beginning of the period the debtors provided 50% of the cover for the bank debt: at the end, under 30%.

Example XXVII

MONTHLY FIGURES OF 'LIGHT ENGINEERS LIMITED'

Work-in-progress	Stock	Debtors		Total Current Assets	Bank debt	Debtors/ Bank Ratio
		Amount	Percentage of total current assets			
£	£	£	%	£	£	%
6,464	14,898	8,258	28	29,620	15,976	52
6,722	14,168	8,420	29	29,310	16,520	52
7,500	15,446	9,744	30	32,690	19,078	51
8,338	15,914	10,446	30	34,698	21,466	48
11,428	17,102	7,326	20	35,856	20,636	35
11,762	17,294	9,544	25	38,600	22,340	43
13,310	17,012	5,976	16	36,298	20,450	29

The warning was clear. Further enquiry revealed that the company had devoted a substantial part of its productive capacity to developing a new and untried product and by the end of the period no less than £10,000 of the ostensible current assets consisted of completed or partly completed prototypes. This fact accounted for the fall in sales and the increase in stocks. As the £10,000 expenditure was clearly of a capital nature, the current assets available as cover for the bank should be reduced to £26,300; and the debt exceeded the agreed lending basis by £2,800, thus:

	£	£
Bank debt . . .		20,450
Guarantee . . .	4,500	
50% of current assets .	13,150	
	<hr/>	17,650
Excess . . .		<hr/> <hr/> £2,800

The position was forthwith adjusted by taking additional supported guarantees as a temporary measure until the necessary additional capital was obtained.

(2) CURRENT ASSETS AND LIABILITIES

The value of all the figures necessary to ascertain the changing amounts of working capital, and the use of this figure to estimate current profits has been dealt with in Chapter V. The changing working capital figure is one of the most valuable tools in the control of balance sheet advances, and its use could be profitably extended. If the ways in which alone working capital can be changed¹ are clearly understood, a close watch on its fluctuations may give an early warning of over-investment in fixed assets or excessive drawings, as well as of reduced trading profits. It should be added that the interim current liabilities figures should show preferential creditors separately and include the figure for the bank debt *as it appears in the company's cash book*. The discrepancy between this figure and that appearing in the bank's ledger is often great enough (by reason of unrepresented cheques and credits in transit, etc.) to vitiate any calculations based partly on the bank's figure and partly on others from the company's books.

(3) CURRENT ASSETS AND LIABILITIES, PLUS WAGES, PURCHASES AND SALES

An even closer picture of current trading can be obtained if monthly purchases and sales figures are added to the items previously mentioned; the wages figure can usually be obtained from the bank account itself. Where the lending is 'near the bone', there need be no hesitation in calling for the additional information. Its preparation for the bank involves little extra work in the company's office, and the actual preparation of the figures will often be of great practical assistance to the directors themselves in shaping production or business policy. Indeed, with the increased employment of Budgetary Control techniques it will often be found that all the figures required are already produced monthly for the

¹ Page 68 *ante*.

Board. An extra copy for the bank will be readily forthcoming and, incidentally sheds useful light on the efficiency of the management.

Example XXVIII

FULL MONTHLY FIGURES

	Purchase (for the month)	Sales	Creditors	Debtors	Stock	Work-in-progress	Bank debt
	£	£	£	£	£	£	£
30 June .	—	—	5,625	8,988	7,984	17,392	13,429
31 July .	3,299	5,744	5,660	9,363	9,015	16,421	14,016
31 Aug. .	4,612	5,994	6,062	8,376	8,783	18,103	13,845
30 Sept.	4,244	6,217	7,014	9,309	9,716	18,457	14,802
	<u>£12,155</u>	<u>£17,955</u>					
						£	
						Wages (from bank account)	7,558
						Estimated overheads (from previous account)	1,800

From these figures it is possible to construct:

- A Trading and Profit and Loss Account for the quarter;
- A cash reconciliation statement.

(a) INTERIM TRADING AND PROFIT AND LOSS ACCOUNT FOR 3 MONTHS
ENDED 30TH SEPTEMBER

	£		£	£
Opening stock .	7,984	Sales		17,955
Purchases . . .	12,155	Work-in-progress		
	<u>20,139</u>	Opening	17,392	
Less Closing stock	9,716	Closing	18,457	
	<u>10,423</u>	Increase		1,065
Materials consumed	10,423	Total production .		19,020
Wages	7,558	NET Loss		761
	<u>17,981</u>			
Prime cost of production	17,981			
Overheads	1,800			
	<u>£19,781</u>			<u>£19,781</u>

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(b) CASH RECONCILIATION STATEMENT

RECEIPTS		PAYMENTS	
	£		£
Sales . . .	17,955	Opening bank overdraft . .	13,429
Less Increase in Debtors . .	321	Purchases . .	12,155
	<hr/>	Overheads . .	1,800
Closing bank overdraft . .	14,802		<hr/>
	<hr/>	Less Increase in creditors . .	1,389
	32,436		<hr/>
Unexplained balance	1,117	Wages . .	12,566
	<hr/>		<hr/>
	£33,553		£33,553
	<hr/>		<hr/>

In this particular account the figures quoted show an increase of working capital during the quarter of £356 which, in the absence of any information about non-revenue receipts, would be *prima facie* evidence of profit earnings. The fuller information enables the banker to infer a non-revenue receipt of £1,117 which, after deducting the loss of £761, exactly accounts for the increase in working capital.

Enquiry prompted by these fuller calculations elicited the information that a motor car which had appeared as a fixed asset in the balance sheet had been sold for £1,050. The slight discrepancy still unexplained could, of course, be due to the difference between the estimated overheads, £1,800, based upon the figures from the previous account, and the actual overhead expenditure.

Where the cash reconciliation statement shows an unexplained balance of payments of any magnitude, the reason should be ascertained. There may have been unwise purchases of fixed assets, excessive drawings, or repayment of long-term loans; all of which will have reduced the liquid resources – one of the basic concomitants of over-trading. In this as in many other killing diseases the value of early diagnosis cannot be overstressed. ‘What doctor would elect to treat a patient on the information afforded by an annual temperature chart? Control is a day to day affair and a more frequent review of the results obtained is necessary if it is to be sensitive and enlightened’.¹ The study of interim figures is the financial specialist’s most profitable activity.

¹ *The Principles and Interpretation of Accounts*, H. L. Ellis.

(4) RECORDS

In order that interim figures may reveal their full story, they should be entered in columnar form on an Interim Figures Record Sheet to be kept in the front of the case file. Changes can then be readily detected and further enquiries made as necessary. A system of monthly or quarterly cards in conjunction with a card 'tickler' diary will help to ensure that all necessary figures are received promptly.

The record sheet will often be the most valuable document in the file. When the next audited balance sheet is received, the interim figures furnished previously for the balance sheet date should be checked against the balance sheet itself. Substantial differences should be explained by the company. The banker's estimate of the reliability of the interim figures may have to be revised as a result.

WAGES

Reference has already been made to the added protection enjoyed by a banker who advances money to a company for the payment of wages.¹ It is advisable to keep such advances on a separate wages account and to make such transfers from the general account from time to time as will ensure that only preferential advances (equivalent to not more than four months' wages and salaries) will be left on the wages account. This device has many times enabled a banker to see a company through its difficulties without undue risk. It should be noted that no preferential status is given under ordinary bankruptcy rules to wages advances made to individuals or unincorporated bodies.

The usual automatic disclosure of the weekly wage total to the banker when the wages cheque is cashed, places a very valuable pulse under his fingers. Particularly in industry, the rise and fall of wages is a very fair index of changes in current production: certainly much more so than purchases or sales. In any case, where a tendency to over-trading is suspected, the banker who makes it his business to watch the wages should be well forewarned. One case comes to mind where the banker had expressly warned a company of the danger,

¹ Chapter XIII *ante*.

and, had the precaution of watching the rising wages closely been taken, he could have acted promptly to save the customer, the bank and the other creditors from heavy losses.

LOANS BY HOLDING COMPANY OR DIRECTORS

There is a tendency, mainly in private companies for the proprietors to furnish the bulk of the cash capital, not by taking up shares (involving a liability for Capital Duty) but on loan. From the company's point of view, this is sound enough. But from the point of view of general creditors and lending bankers alike, it raises several problems which want careful watching.

(1) Unlike capital proper, which (with the exception of redeemable preference shares) cannot be repaid without the sanction of the Court,¹ such loans can be repaid wholly or in part at any time, and without the banker's knowledge. Where a banker is lending substantially to provide working capital he usually relies on the profits earned by the working capital to service his advance. If the working capital is depleted to repay loans, the whole safety of the advance may be undermined.

In such cases the banker may take a charge from each lender over the company's Promissory Note, payable on demand, for the amount of the lender's loan, as security for the company's debt. The banker will then have a right of double proof in liquidation, first for the amount of his debt, and secondly for the amount of the Note.

Alternatively, or in addition, a letter of postponement can be taken from the loan creditors, and acknowledged by the company, which provides:

- (i) that the creditor will not receive nor the company make repayment of the loan in whole or in part (or sometimes so that the loan will not be reduced below £x—), during the currency of the bank advance;
- (ii) in the event of liquidation (when the question of repayment will be taken out of the company's hands) any

¹ Companies Act, 1948. Secs. 66 to 71.

amounts received by the loan creditor on account of his loan will be held in trust for the bank, and as security for any part of the bank's advance not recovered by way of dividend or otherwise.

(2) The broad effect of such a letter of postponement is to make the postponed loan quasi-capital, *as far as the position of the bank is concerned*, through the significance of the qualifying 'quasi' will appear later. Often in liquidation the position of the bank will be stronger with a letter of postponement than if the loan were capitalized as the following example shows.

A financial house of the highest standing, satisfied that under good management a business which had fallen on evil days could be turned into a sound undertaking, bought the shares and put up substantial sums, by way of loan, to modernize the plant and machinery and to finance the inevitable losses during a period of complete reorganization. At the end of the new régime's first year the subsidiary's balance sheet showed the following position:

	£	£		£	£
Capital		200,000	Fixed Assets		225,000
Loan from Parent Co. (Postponed to Bank Loan)		350,000	<i>Current Assets</i>		
			Stock and Work-in- progress	90,000	
			Debtors	290,000	
				<u>380,000</u>	
					605,000
<i>Creditors</i>			<i>Profit and Loss Account</i>		
Preferential	40,000		Balance Forward	80,000	
Ordinary	<u>160,000</u>		Loss for the year	115,000	
		200,000			
Bank Overdraft (Unsecured)		50,000		<u>195,000</u>	
		<u>£800,000</u>			<u>£800,000</u>

It will be noted that:

- Owing to accumulated losses the company, on book figures, is barely solvent, the 'Net Worth' being £5,000 only;
- The current position is strong and reasonably liquid.

- (c) The bank has granted unsecured facilities of £50,000 because the 'stable' is good, and the letter of postponement gives substantial cover: how substantial is worth investigating.

If the business had gone into liquidation on the balance sheet date, the bank's position would have worked out as shown in the table below.

Assets realize	Dividend in £ to non-preferential Creditors	Received and held in trust for the bank by Parent Co.	Dividend on bank advance	Total cover for bank	Bank's £50,000 covered
£ 400,000	12/10	£ 225,050	£ 32,150	£ 257,200	5.14 times
300,000	9/3	162,400	23,200	185,600	3.71 „
200,000	5/9	100,000	14,300	114,400	2.29 „
100,000	2/1½	37,450	5,350	42,800	.86 „ (Loss £7,200)

Thus a 50% realization of the book value of the assets – not unreasonable to expect with debtors alone representing nearly half the total assets – the bank debt is covered over three and a half times. This strong position arises, of course, from the fact that the postponed loan is seven times the bank overdraft, and the bank has the benefit, in effect, of proof for *eight times* its debt. Had the postponed loan been capitalized, however, the position would have been far otherwise.

With a realization of the assets at £300,000 there is a margin of £135,000 over the bank debt in the first table, but only £11,900 in the second: with realization at £200,000, margin £64,400 and shortfall £11,900 respectively. The disparity between the two cases will be narrowed progressively as the excess of the postponed loan over the bank advance decreases.

Assets realize	Dividend in the £	Dividend on bank advance	Margin available	Bank's £50,000 covered
£ 400,000	34/3	£ 50,000	£ 35,700	1.71 times
300,000	24/9	50,000	11,900	1.24 ,,
200,000	15/3	38,100	—	Loss £11,900
100,000	5/9	14,300	—	Loss £35,700

The history of this particular case brought out an additional point of importance. A reduced operating loss of £75,000 was made in the second year. This would have produced a deficiency (negative 'Net Worth') of £70,000. For understandable prestige reasons such a deficiency was considered undesirable by the parent company which accordingly waived its loan and accrued interest thereon to the extent of £75,000, the adverse profit and loss balance being reduced by that amount by a contra credit in the profit and loss account. The banker's natural enquiry whether such waiver was permissible under the terms of the letter of postponement disclosed that it was: and if waiver of part, why not waiver of the whole debt? . . . which would result in the same reduction in cover for the bank as if the loan had been capitalized. Failure or refusal of the loan creditor to prove for the whole debt in liquidation – apparently also permissible – would have the same effect.

It would seem therefore as if, for the proper protection of the bank, the terms of the letter of postponement might well be extended to

- (a) preclude waiver of the loan in whole or in part;
- (b) ensure that in liquidation the loan creditor must prove for the full amount of his loan.

Such a letter can ensure the safety of unsecured lending in a large number of cases, though it cannot be overstressed that it falls far short of providing legal water-tight security: it is only a 'gentleman's agreement'. If more is necessary a legal assignment of the debt should be taken by the bank.

(3) Where a banker holds a floating charge he would naturally expect his debt to take priority over any director's loan. Without his knowledge, however, such director may have been advancing cash to pay wages, and such advances would be preferential and entitled to payment ahead of the bank, to the extent that the wages advanced would themselves have been preferential in liquidation.¹ Provided he appreciated the existence and significance of such a position, an alert branch manager would at once take whatever action might be necessary, including a report to his head office.

EFFECT OF DEBENTURE ON CREDITORS

Where a company is operating on the brink of 'going-concern' insolvency, the banker, when making his summing up of the position, will make some allowance for the possibility – experience suggests that it would be putting it too high to say 'probability' – that the registration of a debenture (which will receive due publicity in the commercial gazettes and in the appropriate trade papers) may lead to some curtailment of his customer's credit. Should this occur to any significant extent, estimates of the cash required for future working and of the adequacy of the facilities sought, may have to be revised. The fear of repercussions following the inescapable publicity is usually, however, more real to the customer than to the bank. It is felt that in practice this fear is generally exaggerated.

MISUSE OF FACILITIES

In the previous chapter it was pointed out that the purpose for which an advance is sought is a crucial factor in deciding whether the advance is sound bank lending. It follows, therefore, that one of the most important aspects of control is to ensure that the facilities are used for the agreed purpose *and nothing else*. It is here that a watchful branch manager can so effectively protect the interests of his bank.

For example, an advance has been approved to furnish additional working capital to finance a seasonal peak or a

¹ Companies Act, 1948, Sec. 319 (4).

special contract. If, in the event, it is used wholly or to a significant extent, to finance:

- (a) The purchase of fixed assets;
- (b) The payment of dividends or arrears of taxation;
- (c) The making or repayment of directors' loans;

the whole picture as envisaged by the banker when the facilities were agreed will be altered, and the expected self-liquidating character of the advance fundamentally changed.

The daily examination of the paid cheques will often give invaluable information. It is an indispensable precaution where the lending is 'near the bone'.

This chapter will have emphasized the fact that there are no easy formulae for the lending banker. The technique of practical advance control must emerge as a slow and natural growth from the application of established principles to individual cases. The banker's proper equipment is a sound understanding of accounts, a wide knowledge of men and affairs together with an alert, vigorous and flexible mind; and above all, plenty of common sense.

CHAPTER XVI

CONCLUSION

THROUGHOUT this book emphasis has been placed consistently and deliberately upon the 'going-concern' rather than the outmoded 'gone-concern' approach to the balance sheet of a borrower. The value of fixed assets (which is quite a different thing from their book value) as a cushion to fall on in case of trouble has, of course, been fully recognized, but unless the 'going-concern' prospects are satisfactory the banker must think twice before he becomes involved at all. Balance sheet valuations of fixed assets make no attempt to indicate realizable value even at the balance sheet date; much less on break-up.

'For balance sheet purposes assets are usually valued on the basis of a "going-concern", not on that of an undertaking about to be closed down. Otherwise, how many even prosperous concerns could bear the test of solvency? The question of actual value, therefore, resolves itself more often than not into one of the prospects of the business continuing a successful existence. . . . So long as the business is prosperous and promises to continue prosperous, well and good. There is no reason why it should not be disposed of as a "going-concern" and the balance sheet values prove to be fully justified. But . . . if a business is steadily declining, the value of at least certain assets are (probably) declining much more rapidly in proportion.'¹

On the walls of many an Alpine town, nestling under the shadow of the towering mountains, can be read the notice,

'Attente aux chutes de pierres.'

The second main theme of this book is the importance of detecting trouble early. The small stones are often the harbingers of the avalanche. A financial land-slide also has its preliminary signs: and if the banker fails to observe them, and cannot retreat in time, he will certainly be involved in trouble and possibly loss.

¹ *Business Balance Sheets*, F. R. Stead.

When the avalanche really starts, there is a gathering of momentum. The assets of a business are disposed of in accordance with a natural pattern. First cash disappears: the pressing need for cash will then dictate what follows. Creditors will be stretched to the limit. Money will be raised on the security of any available assets. Bills receivable will be discounted. Investments will be sold, possibly at a loss if markets are unfavourable. Stock will be sacrificed, the best and most readily saleable stock going first. Debtors will be pressed, and the best of the book debts collected. When a receiver or liquidator ultimately steps in, little but the husks may remain.

Even more important than the early detection of trouble is to forestall it altogether by a searching and understanding assessment of character. 'Know your man.' A banker's customer cannot be treated as a commercial robot. He is human. The banker who shows undue distrust invites knavery and sharp practice; but he who shows confidence is often rewarded by loyalty. A knowledge of men and affairs is even more important than a mastery of figures. In this, as in many another sphere, 'The proper study of mankind is man.'

But above all the *leitmotiv* of this book, which it is hoped will come back to the reader again and again, when other themes may have been forgotten, is LIQUIDITY, actual or potential. Cash must be available, or obtainable, in every business in the right quantity at the right time. Its presence means vigour and stamina: its absence weakness and instability. The flow of cash is the ultimate test of sound business and sound lending alike.

Finally, the repeated warnings of possible dangers must be read with a proper sense of proportion. In the vast majority of cases, borrowing is conducted in a way satisfactory to both banker and borrower. Repayments are regular, and the fundamental requirement of liquidity is satisfied. If undue stress has been laid on the comparatively few cases where caution and precaution are necessary, it is because it is just in this field – small though it may be – that the banker is most likely to make losses. That such cases are so comparatively rare is at once a tribute to the general probity of the business community, and to the traditional shrewdness of the British Banker.

APPENDIX I

THE ASSETS OF THE CLEARING BANKS (£ million)

•	31st December 1937		31st December 1942		31st December 1947		31st December 1952	
	£ m/m	%	£ m/m	%	£ m/m	%	£ m/m	%
1 Cash, Money at Call, Balances with other Banks and Items in transit	480.3	18.6	718.7	18.6	1,233.8	19.5	1,398.8	20.0
2 Marketable Investments . . .	634.7	24.6	1,120.0	29.0	1,482.8	23.4	2,148.2	30.8
3 Treasury Bills	—	—	—	—	—	—	1,182.2	16.9
4 Treasury Deposit Receipts . . .	—	—	895.5	23.2	1,288.0	20.3	—	—
5 Discounts, Loans and Advances .	1,284.5	49.8	970.3	25.1	2,011.9	31.8	1,815.1	26.0
6 Liability of Customers for acceptances, etc.	114.2	4.4	93.1	2.4	246.4	3.9	365.9	5.2
7 Fixed Assets	68.5	2.6	66.3	1.7	68.1	1.1	76.9	1.1
TOTAL ASSETS	2,582.2	100.0	3,863.9	100.0	6,331.0	100.0	6,987.1	100.0

From the Bankers Magazine: the 1937 figures are weekly averages for December: the figures for the other years are end-year figures.

APPENDIX II
ACCOUNTS OF 'MANUFACTURERS LIMITED'
FOR THE THREE YEARS ENDED 31ST MARCH 1948
FACTORY ACCOUNT, YEAR ENDED 31ST MARCH 1946

	£	Transfer to Trading Account	£
Stock, 31/3/45	2,000	Work-in-progress:	99,000
Purchases	10,000	31/3/45	3,500
		31/3/46	7,500
Less Stock, 31/3/46	12,000		
	5,000	Increase in Work-in-progress	4,000
Materials consumed	7,000		
Wages, power and expenses	50,000	Total Production	103,000
Cost of production	57,000		
Factory profit	46,000	(46.5% on transfers, £99,000)	
	£103,000		£103,000

TRADING ACCOUNT

	£	Sales	£
Stock, 31/3/45	7,000		212,000
Own Manufacture	99,000		
Purchases	43,000		
	149,000		
Less Stock, 31/3/46	20,000		
Cost of goods sold	129,000		
Wages and Warehouse expenses	32,000		
Cost of sales	161,000		
Gross profit	51,000	(24% on Sales)	
	£212,000		£212,000

PROFIT AND LOSS ACCOUNT

Debenture Interest (Gross)	£	Factory profit	£
Directors' Fees	3,500	Trading profit	46,000
Overheads	5,000	Sundry receipts	51,000
Provision for depreciation	10,000	(26.7% on Sales)	1,500
Net profit	23,400		
	56,600		
	<u>£98,500</u>		<u>£98,500</u>

PROFIT AND LOSS APPROPRIATION ACCOUNT

Provision for taxation	£	Balance from last year	£
Written off discount on Debentures	35,000	Profit for the year	14,100
Interim dividend paid	700		56,600
Provision for final dividend	20,000		
Balance	5,000		
	10,000		
	<u>£70,700</u>		<u>£70,700</u>

BALANCE SHEET, 31ST MARCH 1946

	£		£	£
Share Capital . . . . .	.	.	.	.
Reserve . . . . .	.	.	.	100,000
Profit and loss appropriation account . . . . .	.	.	.	1,400
				<hr/> 98,600
<i>Net worth.</i> . . . .	.	.	.	.
5% Debentures, secured . . . . .	.	.	.	70,000
				<hr/> 20,000
Current Liabilities:				
Provision for Taxation . . . . .	.	.	.	7,000
Provision for dividend . . . . .	.	.	.	2,000
Creditors . . . . .	.	.	.	<hr/>5,000
				<hr/> 153,600
<i>Total fixed assets</i> . . . . .	.	.	.	.
Current Assets:				
Raw Materials . . . . .	.	.	.	5,000
Work-in-progress . . . . .	.	.	.	7,500
Stock of finished goods . . . . .	.	.	.	20,000
Debtors . . . . .	.	.	.	24,500
Bills receivable . . . . .	.	.	.	2,500
Tax reserve certificates . . . . .	.	.	.	5,000
Quoted investments at cost . . . . .	.	.	.	3,500
(Market value, 31/12/46 £3,841)				
Cash at bank and in hand	9,000
				<hr/> 77,000
Discount on debentures	2,100
Less written off	700
				<hr/> 1,400
				<hr/> £232,000

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YEAR ENDED 31ST MARCH 1947 FACTORY ACCOUNT

	£		£	£
Stock, 31/3/46	5,000	Transfer to trading account	.	.
Purchases	100,000	Work-in-progress:	.	.
		31/3/46	.	7,500
		31/3/47	.	15,000
Less Stock, 31/3/47	105,000			
	10,000	Increase in Work-in-progress	.	7,500
Materials consumed	95,000			
Wages, power and expenses	148,000	Total production	.	282,250
Cost of production	243,000			
Factory profit	39,250	(14.3% on transfers, £274,750)		
	<u>£282,250</u>			<u>£282,250</u>

TRADING ACCOUNT

	£		£
Stock, 31/3/46	20,000	Sales . . . . .	.
Own manufacture	274,750		.
Purchases	75,250		.
			.
Less Stock, 31/3/47	370,000		
	40,000		
Cost of goods sold	330,000		
Expenses	12,000		
Cost of Sales	342,000		
Gross profit	48,000	(12.3% on Sales)	
	<u>£390,000</u>		<u>£390,000</u>

BALANCE SHEET, 31ST MARCH 1947

	£			£	£
Share capital . . . . .	.	.	.	.	100,000
Reserve . . . . .	.	.	.	.	1,400
Profit and loss appropriation account . . . . .	.	.	.	.	98,600
<i>Net worth . . . . .</i>	.	.	.	.	75,000
5% Debentures, secured . . . . .	.	.	.	.	20,000
Current Liabilities:					
Provision for Taxation . . . . .	.	.	.	.	7,000
Provision for dividend . . . . .	.	.	.	.	2,000
Creditors . . . . .	.	.	.	.	5,000
					<hr/> 158,600
<i>Total fixed assets</i>	.	.	.	.
Current assets:					
Raw materials . . . . .	.	.	.	.	10,000
Work-in-progress . . . . .	.	.	.	.	15,000
Stock of finished goods . . . . .	.	.	.	.	40,000
Debtors . . . . .	.	.	.	.	17,000
Bills receivable . . . . .	.	.	.	.	5,000
Cash at bank and in hand . . . . .	.	.	.	.	10,000
					<hr/> 97,000
Discount on debentures . . . . .	.	.	.	.	2,100
Less written off . . . . .	.	.	.	.	1,400
					<hr/> 700
					<hr/> <hr/> £256,300
					<hr/> <hr/> £256,300

YEAR ENDED 31ST MARCH 1948

FACTORY ACCOUNT

	£	£	£
Stock, 31/3/47	10,000		232,000
Purchases	90,000	Transfer to trading account	
		Work-in-progress:	
		31/3/47	15,000
		31/3/48	50,000
Less Stock, 31/3/48	10,000		
		Increase in Work-in-progress	35,000
Materials consumed	90,000		
Wages, power and expenses	148,000	Total production	267,000
Cost of production	238,000		
Factory profit	29,000	(12.5% on transfers, £232,000)	
	<u>£267,000</u>		<u>£267,000</u>

TRADING ACCOUNT

	£	£	£
Stock, 31/3/47	40,000		354,000
Own manufacture	232,000	Sales	
Purchases	100,000		
Less Stock, 31/3/48	372,000		
	50,000		
Cost of goods sold	322,000		
Expenses	12,000		
Gross profit	20,000	(5.65% on Sales)	
	<u>£354,000</u>		<u>£354,000</u>

BALANCE SHEET, 31ST MARCH 1948

	£		£	£
Share capital	100,000	Freehold factory, at cost	100,000	
Reserve	30,000	Less depreciation	1,400	
Profit and loss appropriation account	14,300			98,600
		Plant and machinery, at cost	75,000	
<i>Net worth.</i>	144,300	Less depreciation	20,000	
5% debentures, secured	70,000			55,000
		Fixtures and fittings, at cost	7,000	
Current Liabilities:		Less depreciation	2,000	
Provision for taxation	14,000			5,000
Provision for dividend	10,000			
Creditors	43,000	<i>Total fixed assets</i>		158,600
Bank overdraft	5,000			
		Current assets:		
		Raw materials	10,000	
		Work-in-progress	50,000	
		Stock of finished goods	50,000	
		Debtors	17,000	
				127,000
		Discount on debentures	2,100	
		Less written off	1,400	
				700
				<u>£286,300</u>

NOTE: There is a contingent liability in respect of bills discounted.

APPENDIX III

THE COMPANIES ACT, 1948

INDEX to the most important Sections relating to accounts, and of interest to the lending banker.

SECTION	SUBJECT MATTER
54	Company prohibited from providing financial assistance, <i>either directly or indirectly</i> , for the purchase of its own shares or those of its holding company.
56	Power to issue shares at a premium, and the treatment of such premiums in the accounts.
57	Power to issue shares at a discount, subject to the sanction of the Court.
58	Power to issue redeemable preference shares, and procedure on redemption: 'capital redemption reserve fund'.
60	Power to create a reserve liability on shares.
61	Power to alter the structure of the share capital of a company.
65	Power to pay interest out of capital on capital raised to finance long term construction of capital assets.
66	Power to reduce capital, subject to the confirmation of the Court.
95	Charges by a company which require registration: the effect, <i>vis-à-vis</i> creditors and the liquidator, of failure to register.
147 and 148 149	{ Obligation to keep proper accounts and to submit them to the company in general meeting. Obligation for the form and content of balance sheet and profit and loss account to comply with the provisions of the Eighth Schedule.
150	
151, 152	Obligation of holding company to submit group accounts.
151, 152	Form and content of group accounts: consolidated accounts, where laid, to conform with the provisions of the Eighth Schedule.
154	Definitions of holding and subsidiary companies.
155	Signature of balance sheet.
156	Obligation to attach profit and loss account, group accounts and the auditor's report to all balance sheets published.

- 157 Directors' report, including the amount of dividend recommended and proposals for transfers to reserve, to be attached to all balance sheets laid before the company in general meeting.
- 158 Persons entitled to receive copies of accounts and auditors' reports.
- 190 Prohibition of loans to, and the giving of security or guarantees by a company for, a director of that company or its holding company. Exemption for an exempt private company (*vide* Sec. 129, and the Seventh Schedule).
- 196 Obligation to disclose in accounts the remuneration of directors, including expense accounts.
- 197 Obligation to disclose in accounts particulars of loans to directors and other officers of the company: exemption for banks and others whose business normally involves lending.
- 206 Arrangements and reconstructions, with the sanction of the Court.
- 222, 223 Grounds upon which the Court may wind up a company.
- 319 List of preferential creditors in company liquidation, including loan creditors whose money has been used to pay wages and salaries which, had they not been paid, would have themselves been preferential.
- 322 Invalidity in liquidation of a floating charge created by an insolvent company, excepting as security for fresh money advanced at or after the time of creation.
- 331 Provides that in any form of winding up the disclosure of any failure to have kept proper books of account, as defined in the section, shall render all officers of the company who are in default liable to terms of imprisonment. Although the section only operates after liquidation, it has the effect in practice of imposing on all companies a wide range of detailed book-keeping obligations, in addition to the requirements of the Eighth Schedule as to the form and content of balance sheets and profit and loss accounts.
- 433 Obligation of banking and other companies to exhibit each February and August, a statutory statement of liabilities and assets.
- 454 Power of the Board of Trade to make orders to amend, *inter alia*, the requirements of the Act in relation to accounts.
- 455 Interpretation (meanings of expressions used in the Act).

FIRST SCHEDULE

Table A. Regulation 79. Limitation of directors' borrowing powers to the amount of the company's issued capital, unless this regulation is expressly excluded, or incompatible with special Articles of Association registered.

SEVENTH SCHEDULE

Conditions precedent to the status of a company as an exempt private company.

EIGHTH SCHEDULE

Part I General provisions as to accounts.

Part II Special provisions applicable to holding and subsidiary companies.

Part III Exceptions for banking, discount and assurance companies.

Part IV Definitions, including those of 'provision' and 'reserve'.

NINTH SCHEDULE

Requirements as to content of the Auditor's report.

NOTE: *The foregoing notes are intended as signposts only. They are not intended, and should not be relied on, as statements of the law. The Act itself should be consulted for precise information.*

APPENDIX IV

CERTAIN accounting terms appearing in this book and in common use in the United Kingdom are not usually met with in published American accounts and accounting literature. To assist American readers as well as to help British readers who, in their keenness to enlarge their knowledge, take an interest in the very widespread advances which have taken place in the field of accountancy across the Atlantic, an attempt has been made to list some of the terminological differences between the two countries.

These differences seem to arise mainly from two distinct classes of causes:

- (1) The very different legal framework within which companies operate in the two countries; and
- (2) more subtle divergencies in mental approach.

In the first class, while the United Kingdom common law is the foundation upon which the legal structures of both countries have been built, there is no exact American counterpart to the U.K. principle that a company's capital can only be reduced by order of the Court, after the fullest enquiry. Arising from this, a British company cannot use its resources to acquire its own shares; give financial assistance to anyone else, either directly or indirectly, to acquire such shares, or those of its holding company;¹ pay dividends out of capital; or, except with the sanction of the Court, issue shares at a discount.² In the U.S.A. there are considerable variations from state to state: in many it is both permissible and customary for a corporation to buy its own shares, though in some states, only out of revenue reserves specifically set aside for the purpose. Such purchases are shown in the balance sheet as 'Shares in Treasury' or, simply, 'Treasury Stock', and normally appear as deductions from the respec-

¹ Companies Act, 1948: Sec. 54.

² *ibid.* Sec. 57.

tive classes of capital stock. In this way the net figure for capital stock can fluctuate considerably from year to year. There are inter-state differences in the extent to which it is possible to pay dividends out of capital; this can be done in the State of Delaware, for instance, by a procedure which is illegal in the State of New York. The issue of shares at a discount is generally permissible in the States. The practice there of issuing shares of no par value has no British equivalent: theoretically and practically it has much to recommend it. It should perhaps be stated that the term 'no par value' is somewhat misleading, for the price of issue or 'stated value' is usually just as inviolable as capital (and premiums on shares issued at a price above nominal value) in the United Kingdom.

The second class offers a fascinating field for philosophic speculation, for which, however, this is not the place. It may be noted briefly that there is a characteristic tendency for the American accountant to be at once more dynamic and subjective in his choice of terms: the U.K. equivalents indicate a more objective approach. This line of thought is illustrated by the following examples:

U.S.A. (<i>active, subjective approach</i>)	U.K. (<i>objective description</i>)
Inventory (inclining towards <i>stocktaking</i>)	Stock
Collectibles or receivables	Debtors
Goods in Process	Unfinished goods or Work-in-progress

The regrettable absence of standard accounting terms in both countries has made it difficult to draw up an exact list of equivalents, especially because, owing to variations in commercial practice, terms with the same general connotation are used in the two countries in relation to slightly different underlying facts. It has only been possible, therefore, to indicate a broad correspondence in terms. Most of those which will be well understood in both countries have been omitted.

GLOSSARY

U.K. TERM	AMERICAN EQUIVALENT
Account	Statement
Advances to (associated company) •	Indebtedness of (affiliate)
Authorized Capital	Authorized Capital Stock
Associated Company	Affiliate
Appropriation Account (<i>see under Profit and Loss</i>)	
Bad Debts	Uncollectible notes (or accounts) Uncollectibles
Balance sheet	Same: or Statement of Condition (the latter mainly used by banks and financial institu- tions)
Bank overdraft	<i>Illegal</i> : Bank advances are taken on notes
Basis of valuation (of assets in balance sheet)	Basis on which stated
Bills	Notes
Bills payable	Notes payable (this item will in- clude bank loans, which are, however, usually shown as a separate item)
Bills receivable	Notes receivable, or Notes collectible
Capital reserves	Same: or Capital surplus
Carriage	Freight
Company	Corporation
Creditors	Accounts payable
Debentures	Bonds Mortgage Bonds (the word 'debenture' is used as a gen- eral non-technical term to embrace all borrowings, whether secured or not)
Debtors	Accounts receivable Receivables Collectibles
Depreciation	Same: or obsolescence (where associated with physical wast- age or deterioration) Amortization
Director	Depletion Same

262 BALANCE SHEETS AND THE LENDING BANKER

U.K. TERM	AMERICAN EQUIVALENT
Discount on Debentures	Bond discount Unamortized expenses of bond issue
Double account form	<i>No U.S.A. equivalent</i>
Doubtful debts	Doubtful notes and accounts
Freehold and leasehold properties	Land and buildings Real estate
Gross profit	Gross income (general term) Gross profit (for commercial and industrial concerns) Gross earnings
Improvements (e.g. improvements reserve)	Betterments
Investments	Securities
Liabilities	Payables
Licences	Franchises
Liquid assets (i.e. the truly liquid part of the current assets)	Current receivables
Loan capital	Debentures (general term) Long-term debt
Mortgage debenture	Mortgage bond
Net profit	Net income (general term) Net profit (commerce and industry) Net earnings
Ordinary shares	Common stock
Payments in advance	Same: or prepaid expenses
Preference shares	Preferred stock
Preliminary expenses	Organization expenses
Profit	Same: or operating surplus
Profit and loss account	Profit and loss statement (commerce and industry) Statement of income and expenses
¹ Profit and loss appropriation account	Statement of earned surplus Reconcilement of surplus
¹ Profit and loss appropriation account (as balance sheet item)	Earned surplus Operating surplus

¹ There is at present no true American counterpart of the English appropriation account. Often allocations of profit to reserve which in England appear in the appropriation account will be debited in American accounts at an earlier stage, while non-trading revenue and expenditure which, in England, find their place in the profit and loss account, are often included in the American statement of earned surplus.

U.K. TERM	AMERICAN EQUIVALENT
Provision (e.g. provision for doubtful debts)	Reserve (for doubtful notes and accounts)
Residual value (in depreciation computations)	Salvage
Security (for a loan)	Collateral
Share capital	Capital stock
Stock	Inventory
Stocktaking	Physical inventory
Surplus (i.e. the excess of net assets over share capital)	<i>No equivalent:</i> 'Surplus' is generally used to mean undistributed or accumulated profit: but see 'capital reserves' <i>supra</i>
Trading account	<i>No equivalent.</i> A running revenue account is usual, starting with sales, then deducting cost or sales (generally detailed in a separate statement). These two items correspond to the English trading account
Undistributed net profit	Earned surplus
Unfinished goods	Goods in process
Valuation	Appraisal
Wages	Same: or Labor: Payrolls
Work-in-progress	Same: or Work in process

AUTHOR'S NOTE

Grateful acknowledgement is made of the assistance received in the preparation of this Appendix from Mr. W. G. Cullen, C.A., member of the American Institute of Accountants and late of Price Waterhouse & Co.

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WORK-IN-PROGRESS (*see* STOCK)

BALANCE SHEET A.

SOLE TRADER

TENANT FARMER

